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FINANCIAL SERVICES INDUSTRY—OVERSIGHT

HEARINGS

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

NINETY-EIGHTH CONGRESS

FIRST SESSION

ON

PROBLEMS, OPTIONS, AND ISSUES CURRENTLY FACING THE FINANCIAL SERVICES INDUSTRY AND THE AGENCIES THAT REGULATE AND SUPERVISE THESE ENTITIES

PART I

APRIL 6, 26, 27, and MAY 3, 4, 1983

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FINANCIAL SERVICES INDUSTRY—OVERSIGHT
Part I

WEDNESDAY, APRIL 6, 1983

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS,
Washington, D.C.

The committee met at 9:30 a.m. in room 538, Dirksen Senate Office Building, Senator Jake Garn (chairman of the committee) presiding.

Present: Senators Garn, D'Amato, Mattingly, Hecht, Trible, Proxmire, and Lautenberg.

OPENING STATEMENT OF CHAIRMAN GARN

The **CHAIRMAN**. The Senate Banking Committee will come to order, the hour of 9:30 having arrived. We do not yet have our first and only witness but as most of you know I could not break the record of the Banking Committee starting absolutely on time for the last 2½ years, so now that the committee has started on time, we will have a brief recess awaiting the Secretary of the Treasury.

[Recess.]

The **CHAIRMAN**. The committee will come to order.

Today marks the beginning of a number of days of oversight hearings on the condition and structure of, and competition within, the financial services industry. I am pleased to welcome Secretary Regan who is going to kick off these hearings and I expect to be announcing the schedule for the remaining days of the hearings in the near future.

As you may recall, we began the 97th Congress in a similar fashion by conducting 7 days of oversight hearings which helped lay the groundwork for the legislation that ultimately became the "Garn-St Germain Depository Institutions Act of 1982." I expect that these hearings will serve the same purpose as the ones that I conducted early in 1981, namely to educate the committee on the problems, options, and issues currently facing the financial services industry and the agencies that regulate and supervise those entities.

Once again, the subject matter of these hearings will be very open-ended, as we gather information on the current status of the financial services industry and explore the future direction of that industry. I expect that we will be receiving testimony on the condition of the industry, the structure and powers of the various components of the industry, the competitive dynamics among depository institutions and between such institutions and nondepository financial intermediaries and the laws and regulations that govern and influence those competitive dynamics.

Two bills enacted during the past two Congresses, the Depository Institutions Deregulation and Monetary Control Act of 1980 and the Garn-St Germain Depository Institutions Act, addressed a number of the structural, pricing, and competitive issues in the domestic financial services industry. However, there are additional complicated and controversial issues that remain as a result of the rapidly changing configuration of the financial services industry. These continuing changes call for a careful review and analysis by this committee, with a view towards determining what legislative changes, if any, the Congress should be considering.

During these hearings we can expect to hear about a number of laws and regulations governing the industry that had their genesis in the turmoil of the 1930's. There are at least three areas that will be focused on which have had a tremendous impact on the evolution of the industry. They are: One, the extent of the separation of commercial banking and investment banking as currently contained in the Glass-Steagall Act; two, the separation of commerce and finance such as is now contained in the Bank Holding Company Act; and three, limitations on geographic expansion of financial institutions which in the case of commercial banks is limited by the McFadden Act and the Douglas amendment. There has been much discussion about various means of addressing these issues and these hearings will provide us with an opportunity to learn more about those concepts and problems.

I look forward to Secretary Regan's statement today and the insight it will provide us.

STATEMENT OF SENATOR PAULA HAWKINS

I wish to commend you, Mr. chairman, for calling these oversight hearings on the financial services industry.

It is most timely for the committee to look at the dramatic changes within the financial services industry to determine whether the current laws and regulatory structure are adequate to meet the needs of the decades ahead.

We are seeing a blurring of traditional industry lines and distinctions.

Security firms are offering banking services while the banks are moving into the insurance and security fields. National retail chains are offering banking, security, and insurance services. And the insurance industry is finding its way into the securities field.

These market-place developments fly in the face of the principal banking laws—the Glass-Steagal and the Bank Holding Company Act—which were designed to separate the business of banking from nonbanking activities.

While the McFadden Act and the Douglas amendment to the Bank Holding Company Act were framed to limit interstate operations of commercial banks, we are witnesssing under technological and economic developments the spread of banking services across State lines.

These developments raise a number of questions that these hearings may help to resolve:

Will the small financial institutions be able to survive the competition from national conglomerates?

Will consumer interests be adequately protected in the impersonal electronic environment?

Will the Nation's economy be strengthened or will it face financial catastrophe in the aftermath of deregulation?

Will the specialized regulatory agencies be able to insure the safety and soundness of a merged financial service industry?

Will the Federal Reserve System be able to perform the function of managing the Nation's money supply without additional powers?

Senator Proxmire, do you have any comments you wish to make?

Senator **PROXMIRE**. Thank you very much, Mr. Chairman. I have no formal statement. I would just like to say how delighted I am to see the Secretary and I want to congratulate him on the initiative in this area. We started the deregulation of our financial institutions in 1980 with substantial legislation. Senator Garn has done a superb job in carrying on in that way. The heart of this it seems to me is that we want to increase competition in every way we can and make it possible for the most efficient institutions to prosper and progress and that's always been the American system that's served us so well in so many other areas.

As far as the specifics are concerned, my mind is open—its not empty—and I'm happy to have the Secretary of the Treasury here.

The **CHAIRMAN**. Thank you. Mr. Secretary, please proceed.

STATEMENT OF DONALD T. REGAN, SECRETARY OF THE TREASURY

Secretary **REGAN**. Mr. Chairman and members of this distinguished committee:

One of our national news magazines begins this week's cover story on banking with this sentence: "Amid the rubble of shuttered banks and shattered fortunes, Congress 50 years ago erected a seemingly impenetrable wall between the securities and banking industries."

Today the Congress and the administration join in opening a crucial round of hearings on the safest and most effective way of dismantling that wall. Unfortunately, our hammers and chisels are not the first to arrive on the scene. Indeed, the financial industry itself has put in motion a series of private actions that have forever changed the banking and securities industries. Those of us in government face the challenge of giving that change direction, regulating that change, and of building a framework for future growth.

That same magazine article I just mentioned contains a chronology of events under the heading: "How the lines have blurred in financial services." The first item is September 1977, "Merrill Lynch introduces Cash Management Account for Upscale Customers." The last item is December 1982, "Banks and S&L's begin offering Money Market Deposit Accounts." I was there for both events! So, I am pleased to help open today's hearing on where we go from here. As we stand on the brink of a general economic recovery in this country, there is no better moment to consider the future of financial institutions.

When I last came before this committee, in April 1981, the condition of our domestic financial institutions and financial markets was in many cases alarming. We wrestled then with the dual problem of improving the immediate economic prospects for the industry while at the same time improving the long-term avenues for competitive growth. I believe we accomplished both of those goals in the Garn-St Germain Depository Institutions Act of 1982 and in the regulatory actions by the Depository Institutions Deregulation Committee (DIDC).

Today we face an industry racing full tilt for profits and prosperity. When I first came to Washington 2 years ago, I began talking about the modernization trends in financial services. My examples included the experiments in automatic tellers, the Shearson American Express entry into the market and my experiences at Merrill Lynch. Today those stories are dwarfed by the hundreds of examples of gas stations and grocery stores with banking facilities, of department stores that sell stocks, of insurance companies that are buying brokerage houses, a furniture store that runs a bank, and a myriad of new financial instruments, as well as over 600 banks and thrifts affiliated with brokerage firms.

In just the last year there have been several developments which illustrate remaining distortions in the competitive powers of depository institutions.

A mutual savings bank has acquired a full-service broker-dealer firm which a Federal Reserve member bank could not do pursuant to the Glass-Steagall Act.

Stock savings and loan associations have been acquired by organizations not closely related to the savings and loan business as is required for banks under the Bank Holding Company Act. In addition, many S&L's are converting from mutual to stock form, and in this way will be able to form holding companies that can engage in any line of commerce.

At least one State has authorized banks chartered under its laws to engage in all aspects of the insurance business, and other States have adopted similar "reforms" in their banking laws. Federally chartered banks are not permitted to engage in insurance activities, and even bank holding companies have only limited insurance powers. Many bank holding companies have expanded beyond their home-State borders seeking greener pastures.

Banks that do not make commercial loans ("nonbank banks") do not come under the Bank Holding Company Act and have been established or acquired by organizations outside the banking business. These holding companies are seeking authorization to expand deposit taking activities interstate. To the extent that their subsidiary banks are not member banks, the Glass-Steagall Act may not apply to the activities of the holding companies or their nonbanking subsidiaries, and to the extent that the Bank Holding Company Act does not apply to nonbank banks the Douglas amendment may not apply either.

While there is no consistent pattern in these actions, none of them is inconsistent with the language of the banking laws as they exist today. These laws were enacted at a time when the differences between financial institutions were almost self-evident and there was no need to cover contingencies that were largely hypothetical. When these laws were written, neither the computer chip, the automatic teller, nor the magnetic plastic card existed. In fact, the only way to cross this country from New York to San Francisco was to go to Chicago—and change trains! But under the competitive pressures of today's financial services marketplace, the old structures are breaking down.

As the committee approaches this matter, I think it is important that consideration be given to some fundamental questions: What is a bank? Why is it different from other kinds of enterprises? Do these differences justify special restrictive treatment, and if so, of what kind?

This question of bank definition is but the first that must be answered as we consider future events. I have been quoted as saying that bank regulators are "panting to catch up" with events in this industry. But the fact is that we need to do more than catch up. We need a plan for leadership that will put us ahead of the game. And that means answering some of the most basic questions about how the public is served. For example:

How will financial services of the future look to the individual depositor or investor? What about the small town bank—the friendly banker who knows your children and has financed your crops and your homes? Can he compete with the financial giants?

Will the individual consumer or small businessman be able to secure funds when he has to compete with big—or at least bigger—business interests?

How does the average saver decide among the wide array of interest bearing accounts being offered by banks, S&L's, insurance companies, securities firms and furniture companies?

Are the walls of financial safety tumbling down in a way that generates too much risk, leaving depositors on the shifting sands of uncertainty and confusion?

These questions are not hypothetical. They are being raised in most communities in America by the collective actions of our financial institutions. And we must answer them with a legal and regulatory framework that protects people and their money, while at the same time fostering competitive opportunities for all members of the financial community.

The administration's view is that a bank, or other federally insured depository, is a special form of financial intermediary which, as a matter of policy, should be treated differently from other commerical enterprises. The laws and policies that govern or are related to banking—deposit insurance, comprehensive regulation and supervision, government liquidity assistance and exemptions from securities laws—are designed to encourage savers to deposit their funds in banks, in preference to other investment media.

For their parts, banks and other depository institutions should, and do, use these funds for the benefit of our economy as a whole—through loans to productive and creditworthy private enterprises and to homeowners. Permitting banks to make other uses of these combined savings flows—to allow them, for example, to capitalize subsidiaries engaged in nonbanking businesses—alters and diminishes their necessary and intended role as intermediaries between savers and productive users of credit. In addition, because so many of our policies favor the deposit of savers' funds in banks, there is also an element of unfairness in allowing banks to use these funds to capitalize businesses that compete with others who must raise their capital without government help. Finally, it is also true that permitting banks to engage in nonbanking activities, either directly or through subsidiaries or service corporations, might threaten their safety and soundness by exposing them to greater risks than are already present in the business of lending.

None of this must mean, however, that banks should be wholly isolated from the mainstream of commerce. Developments in recent years have demonstrated—especially in the financial services area—that the ability of a single enterprise to offer a broad range of services can be important in meeting competition. For this reason, the administration believes that banks should be able to associate themselves with organizations that may legally offer a broad range of financial services, so that banks may take advantage of the access to customers that such an affiliation provides.

However, the process by which financial institutions broaden their services must be rationalized and facilitated. That is why the task this committee has set for itself is so vital, and why I urge this committee to complete its hearings and get on with revision of the banking laws as promptly as possibly. Let me present the administration's views on some of the more important statutory changes we believe are desirable.

BANK HOLDING COMPANY DEREGULATION

As you will recall, last year the administration submitted legislation (S. 2490) the Bank Holding Company Deregulation Act, as a conceptual framework for permitting banks to compete fully in the financial services industry. The legislation is designed to expand the powers of bank holding companies and their subsidiaries without affecting the safety and soundness of the banks themselves.

The legislation would permit bank holding companies, through subsidiaries, to engage in any activities the Federal Reserve Board determines by regulation to be "of a financial nature." The bill provides that, in interpreting this phrase, the Board should give primary consideration to the public benefits that would result from increased competition in the financial services industry.

In addition, the bill would specifically authorize bank holding company subsidiaries to engage in insurance underwriting and brokerage, and real estate investment, development, and brokerage. In the securities field, the bill would permit bank holding company subsidiaries to deal in and underwrite U.S. and most State and municipal securities, including revenue bonds. They also could sponsor, control and advise mutual funds and underwrite and distribute their securities.

In the securities area new activities would have to be conducted through a securities subsidiary of the bank holding company, as would all securities brokerage, underwriting, and dealing activities already carried on by the bank. Only if a bank holding company did not engage in the new securities business could it continue to conduct currently authorized securities underwriting or dealing activities within a commercial bank subsidiary.

Our proposal would permit banks which have assets of less than $100 million and are not affiliated with a holding company to conduct new and existing securities activities through a subsidiary of the bank in lieu of forming a holding company. This is intended to hold down the costs for smaller banks. Nonetheless, we are concerned about the potentially adverse impact on small banks of ill-advised subsidiary investments. Under these circumstances, we would like to consider with the Congress whether the small bank exemption is still appropriate.

Mr. Chairman, we believe our proposal will be fair to all the parties concerned and beneficial to the public. In essence, the administration's Deregulation Act attempts to insulate banks from the risks associated with nonbanking enterprises but not to isolate them from affiliation with nonbanking activities. We believe we have the support of the banking and securities industries for the bank holding company concept. We intend to resubmit our legislation as soon as the committee is prepared to receive it.

While on the subject of bank holding company deregulation, I would like to say a word about the recent development of consumer or "nonbank" banks. The committee probably is aware of several decisions by the bank regulators in this area that raise significant legal and policy issues under the Bank Holding Company Act. The act's scope is determined in part by its definition of the word "bank". A bank is defined to mean an entity that takes demand deposits and makes commerical loans. The question has arisen as to whether insured depository institutions should be able to limit their deposit taking or commerical lending activities in a way that will permit them not to be subject to the Bank Holding Company Act. To date several banks have voluntarily foregone commercial lending activities in order to establish a nonbank holding company structure.

We are disappointed that these organizations have found this approach to be necessary in order to compete effectively in the marketplace. We feel there is not good reason to exempt any federally-insured bank from the application of the Bank Holding Company Act. We believe the issue should only be decided by Congress in the context of a full consideration of banking regulation—specifically including the administration's proposal for bank holding company financial services activities.

REGULATORY REFORM

As financial service organizations offer increasingly similar products and services, the burden on them from the present multiplicity of Federal regulators also increases. In many situations a single kind of institution or transaction is governed by several Federal agencies, each applying independent and often duplicative, or conflicting, regulations.

This is one of the reasons Congress established the DIDC, a committee of all the Federal regulatory agencies to deal with the issue of deregulating interest bearing accounts.

The eventual removal of ceilings on all accounts should give depository institutions the flexibility to manage the costs and maturities of their liabilities (deposits) to best fit their assets (investments). Thus, some members of the committee have indicated that at the June DIDC meeting they might support the adoption of a proposal that would remove all the remaining interest rate ceilings on time deposits. Then, the committee's only remaining deregulatory objective would be determining the proper timing for removing the rate ceilings on savings accounts and on NOW accounts with minimum balances under $2,500. It may be time to consider the removal of all remaining ceilings on time and savings deposits. Indeed, it may also be time to consider soon bringing the work of the DIDC to and end!

Just as the DIDC was created to solve a specific problem, other parts of the Federal regulatory system were created in response to other problems or perceived needs. As we consider the future role of the DIDC we also need to analyze the current Federal regulatory structure in light of recent trends in the financial system. The administration has, therefore, established a task group on regulation of financial services under the leadership of the Vice Presdient to complete within a period of approximately 9 months a review of the current regulatory system and to make a report to the President concerning any desirable areas for change. We would welcome the views of this committee either collectively, or individually.

In conclusion, Mr. Chairman, I look forward to working with this committee in developing the legal and regulatory framework for the new era in American finance. Our financial system, with its many investment opportunities, is essential to the very character of our free enterprise system. The right to earn, save and invest with systematic confidence is a cherished value that we must be ever cautious to protect. I am confident that as we deregulate the financial industry—as we develop financial rules that are fair to all—we can provide a sound system of opportunity for the users and providers of financial services.

That concludes my testimony. I will be pleased to answer any questions the committee may have.

[Complete statement follows:]

Testimony of the Honorable Donald T. Regan
Secretary of the Treasury
Before the
Senate Committee on Banking, Housing and Urban Affairs

Mr. Chairman and members of this distinguished Committee:

I appreciate this opportunity to review with you the current state of our domestic financial system and the current issues affecting the system which this Committee must address. Since my last discussion with the Committee on these subjects in April 1981, the condition of our domestic financial institutions and financial markets has greatly improved. A better economic environment is responsible for much of the improvement, but there is also clear evidence that the deregulatory efforts of Congress and the Administration in the Garn-St Germain Depository Institutions Act of 1982 and regulatory actions by the Depository Institutions Deregulation Committee (DIDC) have strengthened the financial system and significantly benefitted consumers. I hope that we can build on this record in the current session of Congress.

CONDITION OF THE FINANCIAL MARKETS

Two years ago, when I was testifying before this Committee, our financial markets and financial institutions were struggling with severe inflationary pressures. The major problem area involved thrift institutions (savings and loan associations and mutual savings banks) and to a lesser extent small commercial banks whose primary business was financing housing. These institutions had structural problems in the mismatch of their asset and liability portfolios. This made it difficult for them to cope with the very high interest rates that resulted from uncontrolled inflation.

At that time, I testified that the Administration recognized that the persistently high rate of inflation was the primary cause of the eroding net worth of thrift institutions. Thrifts were forced to use an increasing amount of short-term deposit liabilities with interest rates that vary with market rates to carry low-yielding, fixed-rate, long-term mortgages made in prior years. This situation, which resulted in the average cost of funds exceeding the average yield on investments, was reducing the thrift industry's net worth by 5 to 10% per year.

As I am sure you are aware, the Administration's economic policies have been successful in reducing the rate of inflation. The Consumer Price Index gained only 3.9% last year and may rise even less in 1983. These increases are well below the double digit gains of 1979 and 1980 and the 9% gain in 1981. The reduction in the rate of inflation has been reflected in lower short-term interest rates. Three month Treasury bill rates have averaged 8.1% in the first three months this year, compared to average rates of 10.6% in 1982 and 14.0% in 1981 when the Administration took office. Lower interest rates and the continued expectation of a low rate of inflation have just begun to be reflected in the net income figures of thrift institutions and should have a very positive influence on income growth in 1983. If short-term interest rates remain at present levels or decline further over the next few years, as we anticipate, thrift institutions should be able to rebuild their net worth substantially from improved earnings. Other financial institutions continue to perform satisfactorily but would certainly do better as the economy gathers momentum.

RECENT AND PROPOSED LEGISLATIVE INITIATIVES

In addition to successfully reducing inflation and interest rates, the Administration worked closely over the past two years with this Committee to develop legislation that would not only provide short-term assistance to troubled thrift institutions but also would further the necessary restructuring of the industry so that it can adjust to future changes in the economy more readily. This combined effort resulted in the Garn-St Germain Act. The Act gives thrift institutions a broader range of powers, including some commercial loan and expanded consumer loan authority for savings and loan associations. The new powers will help these institutions to develop shorter maturing, variable rate assets whose rates can be adjusted to match the cost of deposits more quickly than the return on long-term, fixed-rate mortgages can be adjusted.

The Administration supports the goal of allowing all depository institutions ultimately to perform the same types of business. Over the next few years, thrift institutions should be authorized to increase the proportion of consumer and commercial loans in their investment portfolios. A gradual decontrol of asset powers will enable thrift institutions eventually to offer a full range of financial services to the public. The problems that have faced thrift institutions over the past two years are largely the result of prior government attempts to structure an industry by statute in ways that are not economically feasible. This Administration believes all depository institutions should have equal powers and should be free to choose whatever specialization they wish, based on their individual competitive skills and goals. The ultimate beneficiaries of this flexibility will be the users of depository institutions' services whose special needs could be more readily addressed.

Now that thrift institutions have been provided with broader consumer and some commercial and agricultural lending authority, this Committee and the Administration should work towards removing the remaining usury ceilings on depository institution loans to balance the removal of rate ceilings on deposits. In this regard, I would like to affirm the Administration's strong support for a removal of Federal and state usury ceilings as proposed in S. 730, which was introduced last month by Chairman Garn and co-sponsored by Senators Lugar and Proxmire. If this bill is passed into law and thrift institutions can make a reasonable profit on their expanded consumer and commercial loan authority, the institutions will be encouraged to develop the new asset powers.

The removal of usury ceilings would also benefit borrowers by making it easier for them to obtain credit. The Administration believes that usury ceilings only distort financial markets and credit flows and do not reduce the cost of credit to the economy. Institutions are more likely to lend to all types of borrowers if loans can be priced to reflect the risk exposure. However, as provided for in S. 730, removal of interest rate restrictions should not interfere with the states' authority to impose consumer protection provisions on credit transactions, or their ability to regulate creditors. The Administration also supports the provision in S. 730 which follows the precedent set by the Depository Institutions Deregulation and Monetary Control Act of 1980 regarding the preemption of state usury ceilings on mortgage loans. That is the precedent of giving states a three year period to reject the Federal provisions and to reimpose rate restrictions of any amount and in any form.

Depository Institutions Deregulation Committee

In 1982, the DIDC took two major actions which have effectively halted the outflow of funds from depository institutions. The DIDC, in the context of the Garn-St Germain Act, authorized depository institutions to offer an account that is "directly equivalent to and competitive with money market mutual funds". This ceiling free account, called the Money Market Deposit Account, was first offered by depository institutions on December 14, 1982. By March 16, 1983, the account had attracted about $319 billion of deposits. The huge volume of funds drawn by this account indicates that consumers are happy to keep their deposits in depository institutions, or to move their funds back into depository institutions if the funds earn market rates of interest.

Secondly, as a result of the deregulation schedule that was adopted in March of 1982, rate ceilings have been removed from deposits with a maturity of 2-1/2 years and over. In addition, a ceiling-free NOW, or transaction account, became effective on January 5, 1983. Thus, depository institutions can offer interest rate deregulated accounts for maturities under 31 days and 2-1/2 years and over.

The eventual removal of ceilings on all accounts should give depository institutions the flexibility to manage the costs and maturities of their deposits (liabilities) to best fit their loans and investments (assets). Thus, some members of the Committee have indicated that at the June DIDC meeting they might support the adoption of a proposal that would remove all the remaining interest rate ceilings on time deposits. Then, the Committee's only remaining deregulatory objective will be determining the proper timing for removing the rate ceilings on savings accounts and on NOW accounts with minimum balances under $2,500. The DIDC should probably consider removing all remaining time and savings deposit ceilings. Indeed, it may be time to consider bringing the work of the DIDC to an end.

NEW ISSUES TO BE ADDRESSED

While the achievements of the Garn-St Germain Act and the DIDC have been a good beginning, there is much more work to be done to achieve competitive equality among depository institutions and between depository institutions and other financial service firms. This will make our financial system as efficient and effective as possible, and ultimately benefit consumers. In just the last year there have been several developments which illustrate remaining distortions in the competitive powers of depository institutions.

* One year ago this month, a mutual savings bank acquired a full-service broker-dealer firm; a Federal Reserve member bank cannot do this under the Glass-Steagall Act.

* Stock savings and loan associations have been acquired by organizations not closely related to the savings and loan business as is required for banks under the Bank Holding Company Act. Increasingly, savings and loan associations have been converting from mutual to stock form; this will enable them to form holding companies which can enter any line of commerce.

* At least one state has authorized banks chartered under its laws to engage in all aspects of the insurance business, and other states have adopted similar "reforms" in their banking laws. Federally chartered banks are not permitted to engage in insurance activities or other nonbanking financial services, and bank holding companies have only very limited insurance powers.

* Banks that do not make commercial loans and thus do not come under the Bank Holding Company Act have been established or acquired by organizations outside the banking business, and their holding companies are seeking authorization to expand deposit taking activities interstate. To the extent that these banks are not member banks, the Glass-Steagall Act may not apply to the activities of their affiliates, and to the extent that the Bank Holding Company Act is inapplicable to such nonbank banks the Douglas Amendment to the Bank Holding Company Act may not apply either.

While there is no consistency and pattern in these actions, none of them is inconsistent with the language of the banking laws as they exist today. These laws were enacted at a time when the differences between financial institutions were almost self-evident and there was no need to cover contingencies that were largely hypothetical. When these laws were written neither the computer chip nor magnetic plastic cards existed. But under the competitive pressures of today's financial services marketplace, the old structures are breaking down.

These new consumer attitudes provide a substantial competitive advantage to diversified financial services firms that are not subject to the restrictions on nonbanking activities which are applicable to banks. These organizations can offer a full range of services to the consumer.

That is why the task this Committee has set for itself is so vital, and why I urge this Committee to complete its hearings and get on with revision of the banking laws as promptly as possible.

As the Committee approaches this matter, I think it is important that consideration be given to one fundamental set of questions: What is a bank? Why is it different from other kinds of enterprises? Do these differences justify special restrictive treatment, and if so of what kind? I believe most of the confusion now surrounding the regulation of depository institutions is the result of a failure to focus on these basic questions.

The Administration's view is that a bank or other Federally insured depository is a special form of financial intermediary which, as a matter of policy, should be treated differently from other commercial enterprises. The laws and policies that govern or relate to banking -- deposit insurance, comprehensive regulation and supervision, government liquidity assistance and exemptions from securities laws -- are designed to encourage savers to deposit their funds in banks, in preference to other investment media.

For their part, banks and other depository institutions should and do use these funds for the benefit of our economy as a whole -- through loans to productive and creditworthy private enterprises and through mortgage loans to homeowners. Permitting banks to make other uses of these combined savings flows -- to allow them, for example, to capitalize subsidiaries engaged in nonbanking businesses -- alters and diminishes their necessary and intended role as intermediaries between savers and productive users of credit. In addition, because so many of our policies favor the deposit of savers' funds in banks, there is also an element of unfairness in allowing banks to use these funds to capitalize businesses that compete with others who must raise their capital without government help. Finally, it is also true that permitting banks to engage in nonbanking activities, either directly or through subsidiaries, might threaten their safety and soundness by exposing them to greater risks than are already present in the business of lending.

None of this must mean, however, that banks should be wholly isolated from the mainstream of commerce. Developments in recent years have demonstrated -- especially in the financial services area -- that the ability of a single enterprise to offer a broad range of services can be important in meeting competition. For this reason, the Administration believes that banks should be able to associate themselves with organizations that may legally offer a broad range of services, so that banks may take advantage of the access to customers that such an affiliation provides.

That is why the Administration, in the last Congress, proposed the Bank Holding Company Deregulation Act of 1982 (S. 2490). We expect to introduce substantially the same proposal in this Congress. In essence, the Administration's Deregulation Act attempts to insulate banks from the risks associated with nonbanking enterprises but not to isolate them from affiliation with nonbanking activities.

The sophisticated consumer today would like to include in his savings and investments such things as a NOW account for liquidity purposes, a money market deposit account to earn a higher rate of interest on slightly less liquid funds and securities or even an insurance or annuity contract for long term savings and investment. He would like to do all these things without having to travel to several different financial institutions. He would like all the services offered at one institution and would like the ability to shift his funds from one type of investment to another.

Examples of efforts to acquire and market a broad range of financial services can be seen in Sears' ownership of a savings and loan association, a retail insurance firm and a broker-dealer (Dean Witter Reynolds); in Prudential Insurance Company's acquisition of Bache and in the acquisition by American Express of Shearson.

In the absence of a comprehensive reform of the banking laws at the Federal level, banks have apparently begun looking to the states for relief. Citicorp plans to acquire a South Dakota bank that can offer a wide range of insurance services nationwide; and other banks and other states are likely to follow suit.

This kind of deregulation -- haphazard and without consistency or an underlying concept of what is appropriate for an insured institution -- is obviously unsatisfactory. The process by which financial institutions broaden their services must be rationalized and facilitated. This Committee must address the revisions needed in Federal statutes to insure competitive equality among depository institutions, and between these institutions and other financial service firms. Let me present the Administration's views on some of the more important statutory changes we believe are desirable.

Bank Holding Company Deregulation

Under current law, nonbank financial service firms, which increasingly are competing with banks for the same customers, are less restricted than banks in the variety of products and services they can offer. Many of these firms has been diversifying their product bases to include a broad range of services relating to securities, commodities, insurance, real estate and travel services. As a result of the one-stop convenience that diversification can provide, these firms have been drawing customers away from banks, and the banks are justifiably concerned.

The Administration submitted its Bank Holding Company Deregulation Act as a conceptual framework for permitting banks to compete fully in the financial services industry. The legislation is designed to expand the powers of bank holding companies and their subsidiaries without affecting the safety and soundness of the banks themselves.

The Administration proposal would enable banks to offer nonbank financial services now available only from other financial organizations. Similarly, these organizations doing approved business will be able to establish holding companies and own subsidiary banks. In this manner, banks and other financial organizations will be able to penetrate segments of the financial services industry that are currently separated by statute. This cross penetration should increase the total number of financial service vendors able to provide the same services, thereby expanding competition in the financial services industry and benefitting the public.

The legislation would amend the Bank Holding Company Act, and certain other banking and securities laws, to permit bank holding companies, through subsidiaries, to engage in any activities the Federal Reserve Board determines by regulation to be "of a financial nature." The bill provides that, in interpreting this phrase, the Board should give primary consideration to the public benefits that would result from increased competition in the financial services industry.

In addition, the bill would specifically authorize bank holding company subsidiaries to engage in insurance underwriting and brokerage, and real estate investment, development, and brokerage. In the securities field, the bill would permit bank holding company subsidiaries to deal in and underwrite U.S. and most state and municipal securities, including revenue bonds. They also could sponsor, control, and advise mutual funds and underwrite and distribute their securities.

In the securities area, new activities would have to be conducted through a securities subsidiary of the bank holding company, as would all securities brokerage, underwriting, and dealing activities already carried on by the bank. Only if a bank holding company did not engage in the new securities business could it continue to conduct currently authorized securities underwriting or dealing activities within a commercial bank subsidiary.

• By allowing bank holding companies, rather than banks themselves, to offer a broader range of services, the Administration's proposal accomplishes certain legitimate policy objectives of bank deregulation while allowing banks to associate themselves with firms that can compete for customers with other diversified financial service firms.

As noted earlier in my testimony, banks are unique financial intermediaries affected with a public interest. As such, they are Federally supervised, have access to the Federal Reserve System as a lender of last resort and have some portion of their deposits Federally insured. We do not believe that they should directly engage in activities that are potentially riskier than the banking business. This would place a supervisory and insurance burden on the Federal government that was not intended and is not applicable to competitors offering nonbank financial services. In addition, the unique status of banks enables them to raise money in the private financial markets at a lower cost than most other borrowers. This advantage should not be extended to nonbank activities where banks are competing with independent firms that do not have the same advantage.

We also do not believe that nonbank activities should be conducted through a subsidiary or service corporation in which a bank has a direct equity investment. The investment would be at risk if the subsidiary's activities were to falter, and the funds for the investment would be raised with Federal assistance not available to nonbank competitors and at a cost advantage to the bank.

However, our proposal would permit banks which have assets of less than $100 million and are not affiliated with a holding company to conduct new and existing securities activities through a subsidiary of the bank in lieu of forming a holding company. This is intended to hold down the costs of smaller banks' entering into these activities where the amount of securities business and the risks involved are not as great. Nonetheless, we are concerned about the potentially adverse impact on small banks of ill advised subsidiary investments. Under these circumstances, we would like to consider with the Congress whether the small bank exemption is still appropriate.

While the holding company approach can insulate banks from the risks associated with nonbanking activities, it cannot prevent holding companies from misusing their control over the banks. To deal with these concerns, our proposal includes a series of provisions that regulate banks' transactions with their holding company affiliates. The principle underlying these provisions is that transactions between a bank and its affiliates must be made on substantially the same terms and under substantially the same circumstances, including credit standards, as those prevailing at the time of the transaction for comparable transactions by the bank with non-affiliated companies. These regulatory limitations ensure that not only will banks be separated legally from the risks associated with nonbanking activities of their holding company affiliates, but that they also will avoid relationships with affiliates that would threaten banks' soundness or provide their affiliates with unfair competitive advantages through favorable financing terms or other devices.

The Administration's program contemplates that all subsidiaries of bank holding companies would be subject to regulatory supervision appropriate to the subsidiary's line of business. For example, finance, insurance and real estate activities would continue to be primarily regulated by state agencies. Securities subsidiaries would be regulated as broker-dealers or investment advisers by the Securities and Exchange Commission and state securities regulators, and also may be members of securities exchanges and the National Association of Security Dealers. The objective is to ensure equivalent treatment of functionally equivalent activities. Thus, the framework would permit a wide variety of financial organizations with very different regulatory regimes to be included under the holding company umbrella in a manner that maximizes competitive equality with independent firms.

Mr. Chairman, we believe our proposal will be fair to all the parties concerned and beneficial to the public. We believe we have the support of the banking and securities industries for the bank holding company concept. We intend to resubmit our legislation in the near future as soon as the Committee is prepared to receive it.

"Nonbank" Banks under the Bank Holding Company Act

While on the subject of bank holding company deregulation, I would like to say a word about the recent development of consumer or "nonbank" banks. The Committee probably is aware of several decisions by the bank regulators in this area that raise significant legal and policy issues under the Bank Holding Company Act. The Act's scope is determined in part by its definition of the word "bank". A bank is defined to mean an entity that takes demand deposits and makes commercial loans. The question has arisen as to whether insured depository institutions should be able to limit their deposit taking or commercial lending activities in a way that will permit them not to be subject to the Bank Holding Company Act. To date several banks have voluntarily foregone commercial lending activities in order to establish nonbank holding company structures.

We are disappointed that these organizations have found this approach to be necessary in order to compete effectively in the marketplace. We feel there is no good reason to exempt any Federally-insured bank from the application of the Bank Holding Company Act. We believe the issue should only be decided by Congress in the context of a full consideration of banking regulation -- specifically including the Administration's proposal for bank holding company financial services activities.

Geographic Restrictions on Depository Institution Activities

Over a period of many years Congress has been easing the Federal statutory restrictions on the geographic expansion of depository institution activities, particularly interstate activities. In the Bank Holding Company Act of 1956, no limitations were placed on the operation of nonbank activities across state lines if they were so closely related to banking as to be a proper incident thereto, such as consumer lending, mortgage banking, etc. In 1981 a statutory moratorium on the interstate operation of trust companies was allowed to lapse, permitting trust operations interstate. And last year the Garn-St Germain Act authorized the acquisition of failing depository institutions across state lines by other healthier organizations.

All these legislative changes have followed an even faster erosion of restrictions on interstate activities of depository institutions in the marketplace. Improved transportation and telecommunications have considerably shortened the distances over which business can be conducted from a single location. Even the most sacrosanct of limitations, commercial lending and deposit taking from retail customers, have been modified by the use of out-of-state loan production offices and deposits received by mail. It is rare for a large depository institution today not to have extensive interstate operations. For example, Citicorp and BankAmerica operate subsidiaries in almost every state. They include branches of subsidiary finance companies, Edge Act corporations and mortgage companies.

The Administration favors renewed Congressional efforts to eliminate restrictions on the geographic expansion of depository institution activities. Most such restrictions serve only anticompetitive purposes to the detriment of consumer service and convenience. We recognize the long and difficult process involved in dealing with legislation on this very controversial issue, but we are prepared to work with this Committee to further deregulate restrictive geographic barriers on the rendering of financial services, if there are reasonable prospects for the passage of such legislation.

At the same time many states are easing or eliminating their restrictions on the interstate activities of depository institutions. The New England experience is particularly interesting. Several states in that area have authorized interstate operation of institutions headquartered elsewhere in that region. Local governments familiar with local markets should be able to make sound decisions about their regional economy. Moreover, the strengthening of local institutions prior to a removal of all geographic restrictions nationwide facilitates the potential for development of more organizations able to compete nationally when the opportunity arises. This should enhance the diversity and competitive vitality of the future financial system.

Regulatory Reform

As financial service organizations offer increasingly similar products and services, the burden on them from the present multiplicity of Federal regulators also increases. In many situations a single kind of institution or transaction is governed by several Federal agencies, each applying independent and often duplicative or conflicting regulations. For example, three separate agencies regulate and examine commercial banks, five agencies (and the Department of Justice) have some responsibility regarding mergers or acquisitions involving depository institutions, three agencies provide deposit insurance and one agency regulates bank holding companies, while different agencies may regulate the subsidiaries of the same firm.

Although each part of the current system may have been created in response to specific problems or perceived needs, recent trends in the financial system as a whole have highlighted problems with the current regulatory structure. The Administration has therefore established a Task Group on Regulation of Financial Services to complete within a period of approximately nine months a review of the current regulatory system and to make a report to the President concerning any desirable areas for change.

The Vice President is Chairman of the Task Group and I am Vice Chairman. Other members are the Attorney General; the Director of the Office of Management and Budget; the Chairman of the Council of Economic Advisers; the Assistant to the President for Policy Development; the Chairmen of the Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Federal Home Loan Bank Board, National Credit Union Administration, Securities and Exchange Commission and Commodity Futures Trading Commission; and the Comptroller of the Currency.

The Task Group will develop recommendations where appropriate to improve the efficiency and effectiveness of the present regulatory system in meeting its public policy goals and to reduce the burden of regulation on financial institutions. As part of its work the Group will consider the recommendations of the Federal deposit insurance agencies in their reports requested by the Garn-St Germain Act on ways to improve the deposit insurance system. The Group has also asked for public comments to guide it in its work and has requested the views of all the regulatory agencies. We would welcome the views of this Committee either collectively or individually.

* * * * * * * *

Mr. Chairman, that concludes my testimony. I will be pleased to answer any questions the Committee may have.

The CHAIRMAN. Thank you, Mr. Secretary. I know that you were summarizing your testimony, but in your prepared paper you go into a great deal more detail on other subjects, and so your entire statement will be printed in the record in full.

First of all, on the issue of nonbank banks, yesterday the Comptroller of the Currency, as a matter of fact at 6 p.m. yesterday, issued a statement imposing a regulatory moratorium on the processing of any new applications for Federal charters for nonbank banks, and that will be in effect until next January.

[Complete statement of C. T. Conover, Comptroller of the Currency, follows:]

Comptroller of the Currency
Administrator of National Banks

Washington, D.C. 20219

April 5, 1983

The Honorable Jake Garn
Chairman
Senate Committee on Banking,
Housing, and Urban Affairs
5207 Dirksen Senate Office Building
Washington, D.C.

Dear Mr. Chairman:

In the days immediately prior to the Senate passage of the Garn-St Germain Depository Institutions Act of 1982, a proposal was put forward to change a provision in the Bank Holding Company Act that permitted the chartering of so-called non-bank banks. I strongly opposed that proposal because it was introduced without debate and was inconsistent with the overall deregulatory intent of the new law.

Over the past year, several institutions have sought to expand their retail financial services by establishing banks that do not make commercial loans. These limited purpose institutions have afforded financial service providers an opportunity to expand their consumer service activities in compliance with the federal banking laws.

The delivery of financial services today is more costly and less efficient because of the restrictions on banks' product lines and geographic locations. In an earlier era of regulated interest rates, banks built brick and mortar delivery systems with high fixed costs to gather low-cost deposits. Today in an era of deregulated interest rates, these costs may not be supportable by limited product lines. Technology may be quickly making banks' brick and mortar delivery systems obsolete.

Congress has recognized the significance of these and other structural changes that have already occurred and will continue to occur. This year Congress will hearings on the Glass-Steagall Act, which restricts banks' products, and the McFadden Act and Douglas Amendment to the Bank Holding Company Act, which limit banks' ability to expand geographically. In addition, the Administration will soon re-introduce its proposal to expand the powers of bank holding companies.

In light of the scheduled hearings, I believe that a moratorium on non-bank banks at this time will help foster free and open debate on these important policy issues by reducing the pressure of escalating marketplace innovations at the national level that could outpace Congressional deliberations. Therefore, I am announcing today a moratorium on the approval of new applications for non-bank banks. The moratorium will run to January 1, 1984.

The moratorium does not apply to those few charter applications that were accepted for filing before April 6, 1983. We will continue to accept new applications for non-bank banks, but we will not issue decisions on these applications while the moratorium is in effect. In addition, we will accept and decide most applications for national trust banks and national banks whose acquisition by a bank holding company across state lines is authorized by state law. However, the moratorium will cover decisions on applications for trust banks by organizers who serve as investment advisers to open-end mutual funds.

I want to reaffirm that all non-bank bank charters issued to date by this Office have been in full compliance with all applicable laws. I believe they also represent good public policy. However, I recognize that important, broad policy issues are raised by these charters, as well as other marketplace innovations, that the Congress may wish to debate.

I look forward to working with Congress during this moratorium to examine the full range of changes in the financial services industry, including changes in the savings and loan industry, changes in state laws that affect geographic and product restrictions for state chartered banks, and technological developments that make new financial products and delivery systems possible. I hope that this examination will result in legislation to establish a framework for broad financial services deregulation.

Sincerely,

Todd Conover

C. T. Conover

The CHAIRMAN. Do you support the Comptroller's actions?

Secretary REGAN. Most assuredly, Mr. Chairman. I think that the moratorium is necessary so as not to confuse the issue as this committee listens to testimony and then tries to make decisions on which way it wants to go in this field.

If the regulatory agencies were to supersede the job of Congress, I'd be aghast. I would rather see the Congress handle this issue than to see it done in piecemeal fashion by the regulators.

EFFECTS OF THE MORATORIUM

The CHAIRMAN. What effects do you think the moratorium will have? Do you think it will create more of a tangled web of problems or do you think it will give some time for us to sort out and consider some of these issues?

Secretary REGAN. Well, I hope it doesn't complicate the issue any further. What the Comptroller has said is that his office will process in the normal fashion those applications that are already on hand, by either agreeing with them or disagreeing with them. Those who might want to do the same thing will submit applications to the Comptroller which will be received and held until such time as the Congress makes a decision as to which way it thinks the law should be in this area of nonbank banks.

I think Mr. Chairman, that we must come to grips with the definition of exactly what a bank is and what it is the Congress wants to do with "banks." If the Congress thinks there should be several types of banks—that is, some banks that both accept deposits and make commercial loans as well as other institutions calling themselves banks that only accept deposits or only make commercial loans—then so be it. That's what the intent of the Congress is. But I don't think that we should confuse the issue any more until such time as the Congress has had a chance to wrestle with the problem.

The CHAIRMAN. Do you agree with his recommendation that with regard to those applications already in hand the moratorium should not apply? Although there are only a few in number, one of them involves an application for 31 different institutions across the country.

Secretary REGAN. I understand that and I think that application should have a very careful and lengthy hearing.

The CHAIRMAN. Possibly until next January.

Secretary REGAN. I wouldn't want to put a time limit on it.

The CHAIRMAN. In light of this line of questioning with the Comptroller, do you think the FDIC should take similar action with State chartered banks?

Secretary REGAN. Yes, and I think the Federal Home Loan Bank Board should do the same thing with S&L service corporations. I think there should be a symmetry of action by the regulators to give precedence to the Congress in lawmaking rather than through rulemaking in separate areas.

IMPACT OF THE SOUTH DAKOTA LAW

The CHAIRMAN. On page 5 of your statement you mentioned the recently enacted South Dakota law which allows State chartered banks to engage in the insurance business directly in the bank.

What do you feel is the impact of the South Dakota law and similar laws that may be enacted in the future on the administration's proposal which would require that those types of new financial services be conducted through nonbank subsidiaries or holding companies? You and I had several discussions on that last year—the holding companies versus within the bank.

Secretary REGAN. I am opposed to doing this by the approach of least regulation, which is competition among the States to see who can regulate the least with everyone then rushing to that State to operate under those State laws. I would rather see this done in a bank holding company structure so that regulation could be evened out. I suspect in most States where there are State banking commissions and also State insurance commissions, that if, for example, you have a subsidiary of the bank as the insurance agency, that the regulation will not be even, that it's going to be very difficult for a State insurance commissioner to try to regulate a subsidiary of a bank, because the State banking commissioner will feel some sort of responsibility there. So you'll either have dual regulation or no regulation or confused regulation.

On the other hand, if you have the insurance agency in a bank holding company, there is no compulsion for the banking commissioner to look at that insurance agency. That would be done strictly by the insurance commissioner and therefore there would be equal regulation of the independent agency and the bank's subsidiary. So that's why I'm hopeful that the Congress will supersede the States in this area.

The CHAIRMAN. Well, that was going to be my next question. Keeping in mind the dual banking system, you're recommending at the Federal level that we have a moratorium there as well or an override?

Secretary REGAN. Although I'm not a lawyer, I don't think you could very well supersede a law of the State of South Dakota until such time as this Congress would pass a law to do so, and I hope that the Congress would act rather promptly on this issue so that we don't get 8 or 10 States changing their laws rapidly in order to try to gain some type of advantage over the other States in this area.

The CHAIRMAN. But you are recommending Federal override even keeping in mind the dual banking system and separations we've always maintained?

Secretary REGAN. I think that, as long as banks are going to come under the Federal deposit insurance framework and as long as the Federal Government is going to be responsible as a lender of last resort in order to help these banks if they get into trouble, then the Federal Government should have a right to specify what activities that bank may or may not perform.

Now if they get into areas other than pure banking—and goodness knows there's enough banking, as we all know from seeing some of the loans that have been made by banks—but as they get into other areas that may jeopardize the bank, I think there should be some type of insulation of the bank from these other activities. And the only insulation that we have thought of as being proper is that the activities be conducted in a bank holding company and not by the bank or a subsidiary of the bank.

The CHAIRMAN. As a result of a lot of different reasons—economic pressures, the condition of the economy, technological changes that we have made here in the Congress—the number of merged or failed depository institutions has sharply increased. In fact, not long ago the FSLIC insured as many as 4,500 savings and loans whereas today they are insuring 3,800. The number of commercial banks has also decreased through failure and mergers. And you and I have talked a great deal about this for the last couple years, but one of the greatest problems we face in the Garn-St Germain bill is the fear of the economy being controlled by a very few large financial institutions.

So as the process continues and we continue to work on deregulation, how do you feel we can avoid having a few large banks and the concentration that so many people fear?

Secretary REGAN. I think, Mr. Chairman, that banking is a kind of personal service and a lot of the personality of the bank itself comes into play. People like to deal with someone they know, particularly when they're putting their confidence in that person and revealing in a confidential fashion all of their assets and liabilities. The result, I think, is that most people prefer dealing with a bank in their town rather than a stranger at a distance. Accordingly, I don't think the small town bank or the small bank in a metropolitan area is going to be inundated by these large bank competition.

Obviously, many people who have different types of service requirements might prefer the larger institution, but I know from my own experience in the brokerage field that anyone performing a good service in a local area need not fear the out-of-towner coming into his city.

The CHAIRMAN. The second part of that question is the number of bank holding companies has been reduced rather sharply since 1978; on the other hand, the number of banks with those reduced number of holding companies owned has increased. The major fear here is that that is unfair competition to the very small banks you're talking about.

EQUALIZED COMPETITION FOR SMALL INSTITUTIONS

How do you feel on how we can help to equalize that competition for these small institutions? I understand what you're saying about the personal level of service and all of that, but Walter Riston tells us how Citicorp is remarkably unsuccessful in upstate New York and some of the smaller institutions, but the very technological changes you were talking about—plastic cards and all of that and the Safeway stores with their machines and shopping centers—how do we protect that small bank?

Secretary REGAN. I think that as long as the small bank can perform the vital functions of having competitive rates for savings, offering competitive rates on its loans and offering personalized service, it will be able to compete with the larger institution. I don't think that the Congress need worry that they're going to go out of business or be taken over unless they choose to be. Most of these acquisitions of banks by holding companies have been voluntary on the part of the owners of the bank. Very few of them have been forced into this out of necessity. Of course, many of the mergers in the thrift industry have resulted from failures and that's where the majority of the mergers have taken place. I also think that by pooling their resources, many of these small banks can gain the same advantage that their larger competitors have. For example, a small town bank can have a VISA system just as easily as a large bank can. That puts them squarely in competition with the larger bank.

I also can give you an example in the chain store field. Even though we have large chains like the Safeways you mentioned, we still have a number of smaller individual stores that band together. There are probably more individually owned shops today under the Seven-Eleven brand or franchises of that type than there ever have been in the past. I suspect the same thing would happen in banking. Whether it be interstate banking or large networks of banks, there still will be a need and a place for the smaller banks.

The CHAIRMAN. Thank you, Mr. Secretary.

Senator Proxmire.

Senator PROXMIRE. Thank you, Mr. Chairman.

You started off, Mr. Secretary, with a vivid and dramatic reference to the article that appears in Business Week showing the crumbling Glass-Steagall wall that is being attacked with crowbars and sledgehammers and smashed by the brokers and then by the bankers and so forth. That's still the law, isn't it, and the underlying premise of Glass-Steagall is that there is an inherent conflict of interest between commercial banking and investment banking.

In your judgment, is that conflict still relevant or are past abuses no longer likely to recur?

Secretary REGAN. The potential for conflict is there, but I think it can be handled, given the experiences that we have had in the last 50 years. I think that in today's world, conscious as we are of the way that conflicts can develop, we can isolate these conflicts. That's why we're suggesting the bank holding company method of attacking this problem and doing a little bit at a time to see what problems may arise.

For example, the administration is not suggesting that banks be permitted to do everything in the securities business. We know that they can do pure brokerage business. They already have. Bank of America owns Schwab, for example. We also know that they can underwrite some securities, that is, municipal securities. We're proposing that they be allowed to underwrite revenue bonds. We're proposing that they be allowed to underwrite, distribute, and manage mutual funds. But in each of these cases we're going just a step at a time. We are not racing in and knocking down the wall entirely.

Senator PROXMIRE. Well, I wonder if we should have regulatory reform before we go down that road. Do you think the regulatory agencies are up to speed in this very complex and difficult area?

Secretary REGAN. I think that the regulatory agencies are finding it difficult to keep up with the ingenuity that many of the financial institutions, including banks, have been exhibiting, particularly in recent years, and also the ingenuity of their lawyers in interpreting what the Congress meant 50 years ago by Glass-Steagall.

Now I suspect that what should happen here, Senator, is an effort to keep these people at arm's length between institutions—that is, the customers could have all the services available to them through the bank holding company subsidiaries but not through the bank itself; bankers couldn't commingle bank business with the securities business—I think that's what happened in the 1920's that led to Glass-Steagall. It was the stuffing, frankly, into trust accounts of underwritings that couldn't be sold otherwise. I think that that can be prevented with the Bank Holding Company Act.

Senator **Proxmire**. Was that the principal concern of Senator Glass?

Secretary **Regan**. I think he was concerned about conflict of interest and the safety of the banks. Remember, it was right after the bank holiday that this act was passed.

Senator **Proxmire**. Do you feel that Federal Deposit Insurance, for example, and the other reforms we have had since then also would backstop the situation and prevent the kinds of dangers that developed out of the 1929 crash?

Secretary **Regan**. It certainly protects the money of the depositors to a great extent now if they're under $100,000. I think that's been the great thing about the FDIC, which came in with Glass-Steagall.

Now from the regulatory point of view, I think the modern technology, electronics, and things of that nature mean that there inevitably are going to be regulatory overlaps, that the world has changed, and I think we have to come to grips with it.

What we're trying to do in the Vice President's task group is examine all of these issues to see how we can bring the regulators up to speed and avoid overlap, perhaps by merger, perhaps by reassigning certain activities, and as soon as we've completed that, we would be more than willing to share our findings with this committee.

INVESTMENT IN REAL ESTATE BY BANK-HOLDING COMPANIES

Senator **Proxmire**. Let me get into another area that's related to this. You recommend that bank-holding companies be permitted to make real estate equity investments. Now the Federal Reserve Board I understand has opposed this because they feel the risks are too high. On the other hand, the banks say that the S&L's can make such equity investments through service corporations which give the S&L's a competitive advantage over commercial banks.

I'm concerned about the experience we had with the REIT's. The REIT's, as you know, were relatively insulated. The banks were simply advisers and yet that experience I think was an unfortunate experience.

How should Congress balance the safety and soundness consideration with competitive equity? Should we, for example, forbid S&L's from making these investments?

Secretary **Regan**. No. I would rather go the other way. I would put a percentage limit on the amount of its assets that the bank holding company can invest in this field.

Senator **Proxmire**. A percentage of the assets?

Secretary **Regan**. Of the assets.

Senator **Proxmire**. Such as?

Secretary **Regan**. Well, 10 percent or something of that nature of the bank-holding company assets in the form of equity investment in real estate. Something of that nature I think would suffice. At the same time, it would allow the bank holding company to compete with the S&L's.

Senator PROXMIRE. Mr. Secretary, thrifts have been given checking account and commercial lending powers by Congress. We've done that, as you know. Those powers encompass the traditional definition of a commercial bank.

It may be argued that now we have four bank regulatory agencies where we once had but three and given the propensity of separate agencies to issue different regulations on identical matters—capital adequacy, for example—how do we provide uniform regulations on the safety and soundness and competitive equality for similar institutions?

I've been concerned with that for a long time, as you may or may not know, and one of the additional problems here is what Arthur Burns called competition in laxity in which the regulators try to get as big a constituency as possible and therefore they are as permissive as they can be, and as a result we don't get the kind of effective, strong regulation we should get.

Secretary REGAN. This also is one of the problems that the Vice President's task group is trying to wrestle with. We agree with you that there is a problem here and there should be some solution. I'm not prepared today to give you the answer.

Senator PROXMIRE. I hope you'll think good and long and hard about the possibility of a merger. I realize the Comptroller of the Currency is in the Treasury Department. Each of these regulators tend to say, "Great, provided that we can be the regulator that survives."

Secretary REGAN. I'm not a turf builder in this area, Senator, so I think that I can safely say that we will try to look at it from an overall point of view.

I agree with you that there could be a merger of several of these agencies, at least along certain lines.

Senator PROXMIRE. I just have one other question.

Mr. Secretary, given the rapid changes in the financial system, do you think the time may have come for a single regulatory agency?

Secretary REGAN. I'm not sure that we wouldn't be creating a monster in a single large agency.

Senator PROXMIRE. But this is the only industry that I know of that has such a multiplicity of regulators. We have one Federal Power Commission, one Federal Trade Commission, one FCC, so forth, that regulate particular industries. You don't have multiple restructory agencies which permit the industry to play off one regulator against the other as you do here.

Secretary REGAN. If the Congress goes along with the administration's suggestion and does come up with a bank-holding company formula, which I certainly hope it will, what we are saying there, for example, is that the SEC will be able to regulate the securities field; that if the main subsidiary is a thrift, this would be done probably through a common regulator with the banks, but certainly we wouldn't want the SEC as part of the bank regulatory structure. I'm not sure that you could have an umbrella that would include the SEC and the State insurance commissioners, real estate regulators, and the like at the Federal level.

Senator **Proxmire**. Let me just say I agree with you wholeheartedly that the SEC should not be merged. The SEC has a separate responsibility. I'm talking about just the bank regulators—Comptroller of the Currency, FDIC, and Federal Reserve.

Secretary **Regan**. It's entirely possible that we may come up with that type of answer, but I don't want to anticipate what the task group will say. We're hoping that its report will be available by September so we will be glad to come back and discuss it with you then.

The **Chairman**. Senator Trible.

Senator **Trible**. Thank you, Mr. Chairman.

We've heard, Mr. Secretary, that if the withholding provision is repealed that taxes on banks and thrift institutions may be increased. We've also read that many of the top banks are paying little taxes these days.

TAX INCREASE ON BANKS AND THRIFTS CONSIDERED

Is the Treasury Department considering tax changes that would affect banks or thrift institutions?

Secretary **Regan**. Not specifically, Senator. When we at Treasury were asked by the Senators on the Senate Finance Committee whether or not the banks should be taxed more, we said that we would leave that matter to the Senate of the United States.

Senator **Trible**. So you have no specific suggestion for us here today in that regard nor are you considering recommendations to change the tax provisions?

Secretary **Regan**. Not unless we are called upon to do so.

Senator **Trible**. You have summarized, Mr. Secretary, this morning some of the provisions of the proposal that you would make on deregulating the industry, establishing subsidiaries of bank-holding companies. How does your legislation this year differ from the proposals made last year? Are there differences in pertinent parts?

Secretary **Regan**. No, Senator. although in my testimony I said that we still believed in our S. 2490 and the philosophy behind it, I suggested that we should take another careful look at the $100 million exemption for small banks and whether it is wise to allow the small banks to do some of these nonbanking activities in a subsilliary bank, and whether that might not lead to more trouble than we had anticipated last year.

Senator **Trible**. Essentially, your proposals in the area of bank holding company deregulation would track your proposals of last year?

Secretary **Regan**. That's correct.

Senator **Trible**. Mr. Secretary, the Congress has grappled with this 10-percent withholding provision. Tell me why it is that under current provisions we cannot insure greater compliance with the law.

Secretary **Regan**. Senator, we get millions of 1099's in a variety of forms at the IRS. Some of them come in on magnetic tape. Those we can process very easily. Millions however, come in as separate pieces of paper from thousands of institutions and corporations. To match those up physically with the 90 or 100 million returns that we have is an impossible task. We can only get at part of it with the amount of people that we have available at the IRS.

Accordingly, many of these 1099's are not matched, and if they are matched and a mismatch is found, it is a practical necessity that we go after only the larger amounts and that we ignore the smaller amounts. However, the smaller amounts that we're ignoring amount to billions of dollars.

Unless we literally had an army at the IRS to process these and chase them down, there is no way we can get at these erroneous returns and we never know about the nonreturns of the millions of people who should be paying taxes but who don't file a return. We would never get to match their 1099's against their returns because we wouldn't have a return in the first place.

So, accordingly, withholding seems to us to be the practical answer to catching up with this noncompliance with the law, and we think that it is a far better way to gain the $2 or $3 billion per year to cut down our deficits than to tax people for the same amount. Congress recognizes the deficits are becoming alarmingly large and something has to be done about them, and all we're suggesting in withholding is that we collect the taxes that are due to the United States.

Senator TRIBLE. After withholding then is it your view that there really is no other way to assure full compliance?

Secretary REGAN. If there were a better way, Senator, I would take it, because I don't like the heat any more than members of Congress do. But I have not been able to come up with a better way to do it.

FUNDING FOR THE INTERNATIONAL MONETARY FUND

Senator TRIBLE. Let me move into a different area if I might, funding for the International Monetary Fund. It's not a very popular proposal in Virginia or I dare say in other parts of the country.

Secretary REGAN. Except in some parts of Virginia, Senator.

Senator TRIBLE. Surely there is a requirement for some kind of action. In order for us to adopt a proposal that will increase our funding levels, it obviously will be necessary to impose some safeguards.

What would you have to suggest in that regard? How can I tell my constituents that these kinds of situations will not arise again? Is there a way that we can structure legislation to minimize the chances that these kinds of things will hit us again?

Secretary REGAN. We think that's entirely possible. We are suggesting that this committee adopt certain requirements in conjunction with the passage of the IMF quota allowance which we think is necesary for worldwide peace of mind.

Next Monday the regulators—that is, the Federal Reserve, the Comptroller, and the FDIC—are submitting testimony on this. They are trying to converge in their recommendations. I think that when they submit their testimony, the Senate will be pleased with the work that they have done in putting in safeguards to try to make sure that the banks don't overextend themselves in the international field, so as to jeopardize the American banking system by loans that might go sour outside of our shores.

Senator TRIBLE. Thank you, Mr. Secretary. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you. Before I turn to Senator Lautenberg, I would just comment that the Banking Committee does intend to hold a markup on the IMF quota increase before the end of April and I understand how a lot of people feel, but I would agree with the administration that the quota increase is absolutely necessary.

It is easy to say, "Well, let's stick it to the banks. If they were dumb enough to make those loans, let them suffer the consequences," and I wish the issue were that simple. It is not. It involves a lot of jobs in this country due to our export trader and the ramifications with some of these countries in the international financial system are too grave and the costs, if that system should be in jeopardy, are far, far greater to the taxpayers than an $8.4 billion increase in IMF.

I think the thing this committee is going to have to struggle with, Senator Trible, is just what kind of requirements we place—and I do agree that there are some that are necessary—to try and correct some of the abuses so they will not occur. But we have to guard against going too far.

There are some proposals that I think are an overreaction which often happens. I look back at the Bert Lance affair, and we corrected the Bert Lance type of thing by going far too far, to penalizing a lot of bankers across the country that did not need that kind of legislation. So when we get to the markup this month I hope that the committee can take a balanced approach to the IMF quota increase, further disclosure, and things of that nature that you will see coming in recommendations, but not going so far to satisfy the political urge that we are really sticking it to the banks because I think you also have to look at the encouragement that came from western governments following the Arab oil embargo, the OPEC embargo, where we were doing everything we could to find alternative sources of oil other than from OPEC and were pushing the development of these underdeveloped countries, particularly for energy resources.

So there's a lot of people, a lot of politicians as well, who were all screaming "energy independence, let's get that money out there and let's fund the oil rigs and all of that development so we can get away from OPEC," but it's really unfair to make it very simple and say just if those banks were dumb enough to make those loans—there were a lot of dumb politicians who encouraged them to make them as well.

Secretary REGAN. I'm glad you said that, Senator.

The CHAIRMAN. Not only in our own country but in others. So I just take that opportunity to let people know we do hope to get to that issue before the end of the month and hopefully we can take a measured balanced middle ground between the situation now and overregulation or putting too many restrictions like incountry loan limits. That's credit allocation, whether it's international or not. I happen to be opposed to credit allocation and the Government determining it, but it's an issue that I do think the Banking Committee can deal with intelligently and on a measured responsible basis before the month is over.

Secretary REGAN. We'll be very happy to work with you on that, both in the administration and the Treasury, Mr. Chairman.

The CHAIRMAN. Senator Lautenberg.

Senator LAUTENBERG. Thank you, Mr. Chairman. I know I'm not one of those politicians that you talked about because I've been here too short a time.

The CHAIRMAN. Well, you weren't here.

Senator LAUTENBERG. Mr. Secretary, it's nice to see you. One of the things we're talking about here is definitions and I moved from the far left there—that has no political connotation——

Secretary REGAN. I'm glad to see that, Senator.

Senator LAUTENBERG. But I moved over here and I now have senior rank and the question here this morning is definition or rank or bank, as the case may be.

The CHAIRMAN. Actually, you'd better be careful, Senator, because that's the Secretary's far right from his position. [Laughter.]

Senator LAUTENBERG. We're liable to discover some things in this process. I once sat in that chair at the time of the development of one-bank-holding company legislation, and I wanted the definitions fairly clearly drawn. I was in the computer services business in my civilian days. One of the things that we were concerned about was the intrusion of banks into nonbanking services. Although we lost the battle, we ultimately won the war—based on the economics of providing such services by banks. I was struck by your comment that the opportunity for gathering business depends on one's cleverness, one's ability to segment out the market. I'm sure you know Bank One.

Secretary REGAN. Very well.

Senator LAUTENBERG. I think they've done an excellent job of defining the marketplace and grabbing that marketplace. I'm inclined to believe that there are special opportunities for those clever enough to get them. On the other hand, the definition of a bank, which seems to thread through our hearings, is not as much a concern to me as the definition of banking.

NOT APPEALING FOR BANKS TO LOAN MONEY TO SMALL BORROWERS

I'm concerned, Mr. Secretary, that it will not be appealing for banks to lend money to small borrowers, to small businessmen, to the individual, when there is so much more available in money markets, other kinds of instruments.

In your view, what is likely to be the impact of further deregulation on capital availability for that small borrower? We're looking at a substantial threat to the small bank.

Do you think this further deregulation is going to enhance capital availability and capital formation in the country? Or is it going to simply be a moving item, with investors seeking out the next-best opportunity and not having capital so that the borrower can get his hands on it?

Secretary REGAN. I would have a concern there, Senator, but I think that if there is a service that is needed and can be provided at a profit, then somebody will provide it. As you worry about the consumer, think in terms of why we have this sudden proliferation of nonbank banks and notice what they're doing. They do not want to make commercial loans. They want to make consumer loans. They want to make automobile loans. They want to make the very types of loans that you're talking about.

So here we have a host of nonbankers coming into the banking business willing to take on that segment of the industry, and now the bankers themselves think that the pastures may be greener over on the other side and want to get into more commercial lending through interstate banking which, by the way, they have already undertaken—you have loan-production offices of most major banks in many States and they don't confine themselves to one State. So I think that while they're going after the commercial loans, you will find others coming into consumer lending. And I think, at the same time, the thrifts are going to go into consumer lending. Remember that under the Garn-St Germain Act they're allowed to do that. So I think there's another source of funds that will be available to the consumer. I suspect that capital will be available through these institutions for individuals and small businesses both.

Senator LAUTENBERG. You talked about the expansion of banking capacity beyond State borders. Even if the physical plant isn't in the State, one can participate in networks throughout the country. If you carry the right kind of card when you're in Florida and your bank is in New Jersey you can tap your account and make a deposit and so forth.

What seems to me to be likely to occur is that we will see ever larger banks getting out of the consumer side. I don't think that the borrower can borrow at the same competitive rate that if in fact he's borrowing from the larger institution, the one that's acquiring the capital.

Congress has adopted a policy of avoiding or at least not encouraging excessive concentration of economic and financial resources. Should such a policy be abandoned, as would almost certainly be the case if deregulation were pursued?

Secretary REGAN. No. I think, Senator, I'll stick to what I said originally. I think there will be other sources of funds available. Right now, for example, you can borrow more cheaply through your broker than you can through your banker because brokers' loan rates are cheaper than banks' if you have the collateral, and many individuals are taking advantage of that—professional people and small businessmen. These are not commercial loans, but they are borrowing through a margin account for nonsecurities loans.

At the same time, I think that as we get into further deregulation you will see competition coming for the banks in the area of consumer loans from nonbank financial institutions. It's profitable for them. They're willing to accept less profit margin in order to establish themselves: therefore their rates are more competitive than these of many of the larger banks or the credit card companies.

Senator LAUTENBERG. The person that you're talking about that's borrowing from his broker is not the average wage earner, I don't think; do you, Mr. Secretary?

Secretary REGAN. No. The average wage earner is looking for automobile loans and, for smaller loans than that. Notice that companies such as Beneficial finance and others of that nature have established themselves in the banking field. Why? In order to spread their wings in the field of consumer loans. So, I think that this service will certainly be carried on. I don't think anyone is going to abandon that area or that there will be less capital available.

TRANSACTIONS IN BANKING VERY COSTLY

Senator LAUTENBERG. You're very much aware, of course, of the fact that transactions in banking are very costly to provide—checking accounts and things of that nature. Since the profit motivation is one that we honor and respect in our society, there is, in my view, a likelihood to offer fewer transaction-related service and get into more of the investment type opportunity by the large banks. Again, I'm fearful that the competition for profit opportunity will deprive the smaller businessman and the individual from the borrowing opportunity. Apparently you don't share that view.

Secretary REGAN. No, I don't see that. Again, Senator, remember what we're doing with the thrifts. Gradually, we're allowing them to become more like commercial banks through the Garn-St Germain Act and, I would suspect followup legislation in the years ahead. Accordingly, you have another whole new segment of the financial services industry that will be there for banking—that is, deposit taking, making of small loans, and so forth the like—and a whole new area that will be available to individual consumers.

Senator LAUTENBERG. I think the result will be, however, that you'll see perhaps less profit opportunity for the savings and loans and the thrift institutions because the cost of servicing those checking accounts and so forth has not yet been realized by them for the most part. I'm not proposing that we go back to the old days when interest rates were fixed and it was a relatively comfortable spread between that which they loaned and that which they took in. But I think the full impact has not yet been felt of the cost for servicing accounts by the thrift industry. I think they're going to find it very difficult to stay competitive with the larger banks, with the other institutions that are into the banking business, It gives me cause for concern that as we further deregulate, we will be depriving the small entrepreneur, the small business person.

Secretary REGAN. I think that packages will be offered by service companies in the computer field that will be able to handle this. Certainly automatic tellers are a lot cheaper than people tellers and, I think that ways will be found to cut the cost of handling these small checking accounts.

Senator LAUTENBERG. I'm out of time, but in my former life, one of the services we were rendering was providing a ATM network for the banking community which would be a shared system. It was very helpful to the smaller bank. I want it to be clearly on the record that my being here does not mean that that project was a failure.

Secretary **Regan**. Nor would I want you to think it was the failure of my company that account for the fact that I'm sitting here today.

The **Chairman**. Both of your former companies are doing very well.

Senator **Lautenberg**. Unfortunately, since we've gone.

The **Chairman**. Senator Hecht.

Senator **Hecht**. Thank you, Mr. Chairman.

BANK-HOLDING COMPANIES' SUBSIDIARIES ENGAGE IN INSURANCE UNDERWRITING

Mr. Secretary, on page 5, the last paragraph, "In addition, the bill would specifically authorize bank-holding companies subsidiaries to engage in insurance underwriting, brokerage, real estate investment, development, securities, and so on."

I look at the human element on this and in my 20 years of banking I've seen flagrant abuses of the human element. A man comes in and he has to have insurance on the building the bank just loaned money on and the bank will say, "Well, my brother-in-law down the street sells insurance or a friend of mine." Also, the independent builder, how are they going to be able to get money for a subdivision when the banks can do it? Certainly there's no great mystique to doing a subdivision. How can these type of people operate? Do you really think this is practical?

Secretary **Regan**. Yes, Senator, I do. I'll tell you why. I think that, first of all, we can prevent by far the tie-in sale where a bank refuses to lend unless you also take insurance from it—that type of thing.

At the same time, the thrifts have this power now to lend for subdivisions. Some choose to, some don't. I think the same thing will happen with banks. As I suggested in my answer to Senator Proxmire, I think we can put a limit on the amount of funds that the individual bank could put into direct real estate equity. So, from that point of view, while there might be competition for the builder, I think a lot of builders would welcome the bank as a partner in the subdivision.

I think this would help real estate, rather than harm it.

Senator **Hecht**. Well, I don't really agree with you. I've seen in the last few years when money was so difficult to come by for a builder the banks were really the one spot the independent could go to because of tremendous abuses in the thrifts.

Let's go on to page 6. "The proposal would permit banks which have assets of less than $100 million and are not affiliated with a holding company to conduct new and existing securities activities through a subsidiary," and so on, and so forth.

A $100 million bank today is certainly in a position to hire a securities analyst. It's a baby bank. I question really whether a $1 billion bank would be in that position. I mean, the salary you pay the banker—a $100 million bank today is perhaps 20 years ago a $10 million bank.

BANKS IN SECURITIES BUSINESS

Secretary REGAN. We're saying that we have to have some type of method by which the small bank can still compete with the large bank. The large bank is going to be in the securities business. Remember that the only type of securities business we would allow them to go into would be the underwriting of municipal revenue bonds, which they're not allowed to do now, plus underwriting and distributing mutual funds. One doesn't need an analyst to distribute a mutual fund and it would be logical to assume that a small town bank, a $100 million bank, would be interested only in selling mutual funds. They would not be interested in trying to sell the whole gamut of stock exchange listed stocks or over-the-counter stocks. Accordingly, I don't think that they have to have broadly trained people to sell mutual funds. They have been sold part time by housewives, by people moonlighting and the like, and sold very successfully.

Senator HECHT. But looking down the line, wouldn't this be an invitation to further expand this field and then banking would say, you know, "We don't have enough of a market for mutual funds. We want to sell other stocks. We have people who are borrowing money from us who are using securities as collateral. They cannot pay the loan, so we sell the securities. Wouldn't this be an invitation to open it up further?

Secretary REGAN. Not as yet, I don't think. I think that once having enacted our proposal, the Congress and the administration will have to observe for a period of time and then decide whether they want to allow the bank to go further. At present we are not suggesting that they would be allowed to buy and sell other stocks, although I remind you that over 600 thrifts and banks right now are affiliated with discount brokers and are engaging in the brokerage business. Now they're not recommending stocks. They're merely handling the transaction. But they are doing that today.

Now if that's being done today without congressional oversight, what we're saying is that the Congress should be legislating in these matters and that's why we think you have to come to grips with it. The time for saying whether banks should be permitted to do this has passed because they are already doing it. Bank of America owns Charles Schwab, the example I gave, but there are hundreds of other banks and thrifts that are affiliated in one fashion or another with a discount broker. So if they're already doing it, Congress should decide now what it wants to do in the way of regulation and what it's going to permit.

Senator HECHT. One last question. You mentioned, "What is a bank?" I'm from Nevada. The number one industry is tourism and gaming. This past weekend I conducted hearings with two members from the Treasury Department in Nevada, one day in Reno and one day in Las Vegas, trying to determine that a gaming house was subject to certain bank laws, reporting forms. I think this is long overdue. I think we need it for our State. I think a lot of other people need it.

So the minute you come up with this I would certainly like to know about it because it would have a tremendous impact on our

State. So I compliment you on setting down these different guidelines of what is a bank today.

Secretary **Regan**. We'll be very conscious of that when we come to grips with it, Senator.

Senator **Hecht**. Thank you.

The **Chairman**. Senator D'Amato.

Senator **D'Amato**. Thank you, Mr. Chairman.

Mr. Secretary, it is good to see you. I would like to follow up on Senator Hecht's questions and also express some concerns with respect to the leverage which banks would have and the possibility of their using this leverage over those people who are seeking loans or financing by tying other services which would be offered by banks in a deregulated environment to the allocation of such credit. I believe that this potential problem is something that Congress is going to have to be very mindful of. I wonder if we want to open up the barn door further, then, retrospectively, when the horse is far gone, say, "Well, now we must develop anti-tie-in legislation or legislation that will restrict such activities.

HOW TO REGULATE BY LEGISLATION

The hard question really is how do we regulate, by way of legislation, this subtle kind of pursuasion that may take place whereby, for example, someone who you have been financing over the years needs a construction loan and you, as a bank, are also interested in underwriting some of that real estate development. And perhaps you would also like to insure the premises. How much of a choice does the credit seeker really have in freely pursuing other market alternatives for these other services when his credit source holds such extensive power. Thus, I think it is very important that we deal with these kinds of abuses with legislative language. I think this is just too important an ajea for -us to ignore. What restrictions would such legislative proposals encompass? I think we should examine them before we go ahead and turn over a carte blanche.

Secretary **Regan**. The tie-in sales are now prohibited in banking. There is that separation now through regulation and through certain laws. What I suggested in my testimony was that as soon as the committee signals that it is ready to receive any of this, we at Treasury will be more than happy to submit the language that we would suggest for committee consideration.

Senator **D'Amato**. Well, I, for one, Mr. Chairman, would think that it would be appropriate to begin to look closely at these concerns. Just what kind of provision or legislative language would we use to prevent these kinds of activities from taking place? I do not know whether it is possible. We held hearings last year on Glass-Steagall in my securities subcommittee. We met with numerous people from the securities industry, the real estate industry, the banking industry, to attempt to develop some kinds of proposals that would address this problem. I would welcome your specific suggestions. I think it is very important.

Secretary **Regan**. What you'll have to do, Senator, is have a neat balance. There is no doubt that a lot of people want a one-stop financial service organization. That's why you've seen a proliferation of them. That's what many are trying to do. Sears is a great example.

Now there is a nicety between having the service available and insisting that the service be taken, and I think there's where we're going to have to strike the balance.

Senator D'AMATO. Mr. Secretary, let us continue along this line. In 1932, Senator Glass concluded that the bank directors used undue leverage to direct business to securities affiliates of which they were also directors. Should we move in the direction of prohibiting interlocking directors? Have you then any position on that?

Secretary REGAN. Between what type of institutions, Senator?

Senator D'AMATO. Between the bank-holding company and its subsidiary active in the area of securities. Would you permit there to be interlocking directors?

Secretary REGAN. Yes, I would.

Senator D'AMATO. What about interlocking directors between the bank affiliate and the securities affiliate?

Secretary REGAN. Yes, I would permit that.

Senator D'AMATO. You would permit that?

Secretary REGAN. I would permit that.

Senator D'AMATO. That does not trouble you?

Secretary REGAN. If there is a conflict, it can be dealt with I think, through the securities affiliate's being regulated by the Securities and Exchange Commission. They're diligent overseers and if there's undue influence, I think that can be handled, just as much as the directors of Sears right now have Dean Witter under them, I don't think there's any undue influence of the Sears directors on Dean Witter.

Senator D'AMATO. Mr. Secretary, I do not wish to single out a particular institution, but let us talk, just for a moment about the current South Dakota situation. What do you think about that taking place? Should Congress react to that by way of prohibitory legislation?

Secretary REGAN. I think that the Congress should take over and legislate in this field. I don't think it should be left to different laws among 50 states. And as Senator Proxmire quoted former Chairman Arthur Burns on laxity in regulation, I think that this is what most institutions will be seeking and I think there should be one law for the country in this regard.

This administration and I believe that if the banks are going to engage in insurance activities, they should be done in a bank holding company insulated from the bank itself, and not as part of the bank or a subsidiary of the bank, as the South Dakota law allows.

Senator D'AMATO. I agree with you and I think perhaps our one point of departure might be how do we get there. Do we now say that all banks should be allowed to participate in that activity or should we say, no, wait a second, we are going to rectify that situation and prohibit banks from moving into that area, and then proceed to look more carefully at the situation. Then we would perhaps determine what contitutes an illegal tie-in similar to the type that we were concerned about in 1932 and those that Senator Hecht has suggested do become a reality and might become much more prevalent in the financial marketplace. The small entrepreneur, that person who is attempting to move his business forward would perhaps become much more restricted in his choice of credit alternatives.

So I do look forward to that legislative proposal that would directly address the area of tie-ins. I think it is very important. Thank you very much, Mr. Chairman.

The CHAIRMAN. Senator Mattingly.

Senator MATTINGLY. Thank you, Mr. Chairman.

Mr. Secretary, on the Bush task force on deregulation, do you think emphasizing disclosure on the banks is going to help strengthen the system?

DISCLOSURE OF WHAT BANKS ARE DOING

Secretary REGAN. Yes, I do. I think that the more disclosure we have of what banks are doing, the less jeopardy the banks will place themselves in, since they know they're going to be under the scrutiny not only of security analysts but others in the financial community.

Senator MATTINGLY. With respect to traditional disclosure, do you think it's a necessary complement to traditional bank supervisory and examination techniques?

Secretary REGAN. I think it would be very helpful and would make the life of the supervisors easier.

Senator MATTINGLY. My State, Georgia, is in the midst of the Southeast and very active in interstate banking arrangements. Your written statement supports the concept of interstate banking.

How would you have Congress proceed along in this issue and how would we protect the interest of the small banks that have been serving the small communities like we have in Georgia, or should we?

Secretary REGAN. I think constitutionally you have to give all 50 States the same type of law in this field.

At first I thought, Senator, that perhaps we could do it just by metropolitan areas. Let's take Washington, D.C. as an example. We have two States and the District. Perhaps we should permit interstate banking in this area first. There already is one bank that's grandfathered there. And then perhaps we could do it in New York, which has three different State jurisdictions.

The more I considered it, the more I realized I don't see how you can do it except to permit interstate banking for all 50 States.

Now in order to protect the smaller banks, I think you have to allow for some type of loose affiliation among the smaller banks, if they so desire, for certain services. For example, Senator Lautenberg and I were talking about service companies in the electronic area. Perhaps affiliation for them across State lines could be permitted in order to allow a small bank in a small town to have services that otherwise it couldn't afford or couldn't provide for itself. Although it would not necessarily be owned by or be a part of a large chain of banks.

Senator MATTINGLY. I'm sure there are other examples like this, but I know that in Columbus, Ga., less than 5 miles away is Phoenix City, Ala.

Secretary REGAN. Right.

Senator **Mattingly**. It seems sort of ridiculous to have the regulation controlling that on such a small distance. I'm sure there are innumerable examples like that across the country.

Secretary **Regan**. Yes. Take the two Kansas Cities. It's just ridiculous to think you can bank in one and not in the other. We have all kinds of examples. That's why I think we have to go the full 50 State route all at once to permit interstate banking.

Senator **Mattingly**. Your testimony once again suggests that we deregulate the financial services industry and I would hate for you to go away from here not having the question asked of you at least twice in reference to the tax-raising measure of last year which required banks and other industries to withhold its savings and dividend income. That sort of appears to be sort of a contradiction in the two measures. On the one hand, regulate; and on the other hand, deregulate. Could you comment on that?

Secretary **Regan**. Yes. First of all, I might also comment that we've been talking about the advances in electronics and the way the banks are growing so fast in information technology and now we find in another area that they're unable to grow. That's kind of ironic.

WITHHOLDING INTEREST

As far as this withholding is concerned, Senator, I've wracked my brain and searched the brains in Treasury to try to find an answer to this. Is there a way out of the dilemma we're in? I see none.

Senator **Mattingly**. Would you repeat that? I'm sorry. I got lost.

Secretary **Regan**. Well, what I said is that we in Treasury have been trying our best to determine whether there is a way out of the withholding matter. Is there a better way to collect the taxes that are due on interest and dividends other than through withholding? And after careful throught I'm convinced there is no better way to do it. There are other ways to do it, but they are less efficient and less productive for collecting the taxes that are due to us.

I think there's been a lot of misunderstanding about withholding. Let me give you thinking. What we were trying to do was to discover how we could narrow the gaps that we had between outlays and receipts—the deficit. The obvious question was: Is there any way we can collect taxes better than we're doing to get at this so-called non-compliance area? One of the ways suggested was through withholding because we are convinced, and the IRS has demonstrated that by withholding we can collect more of the taxes that are due. We put in all kinds of exemptions for people so as to make this the least burden we could. We also offered the banks some recovery of their costs in providing withholding. And now having gone through a complete analysis since last November with the industry, I'm convinced the industry can do it; it's not nearly as expensive as they originally had thought. It is burdensome, but with the exemptions, most people would agree that, while painful, it's better that the IRS collect taxes that are due than that the Congress enact new taxes on those who are already paying taxes.

Senator MATTINGLY. Well, I think the Treasury Department has already done a study which suggested that a 97-percent compliance rate is possible if the 1099 forms are matched with the individual tax returns. I think you're aware of that.

Secretary REGAN. Yes. That's a 1977 study of about 500 accounts. It took all the accounts that had sent in a correct social security number, correct description of the account or the security for which the 1099 was prepared, had the correct name and address and so forth. It was then found that the IRS could match up all of these and in those cases they found the amount of compliance that you suggest. But in order to get those 500 names, they had to discard thousands of others where the social security number was wrong, the name was wrong, the name of the security was incorrect—all of these human errors that enter a system—and as I explained in answering Senator Trible about the millions of 1099's that we get at the IRS and our efforts to match them physically with the ——

Senator MATTINGLY. You don't do it physically. You do it by machine.

Secretary REGAN. You have to take the piece of paper and encode the information into the machine.

Senator MATTINGLY. Right.

Secretary REGAN. And to encode the millions of pieces of paper is a herculean task and very inefficient.

Senator MATTINGLY. I know how you want to hold on to revenues, but the idea is to try to find a better way to do it.

Secretary REGAN. Let me tell you this, Senator. We don't want to hold on to the revenue. All we want to do is get that deficit down.

Senator MATTINGLY. That's right. Let's cut spending.

Secretary REGAN. I agree with you 100 percent on that, as well in collecting the taxes that are due to us.

Senator MATTINGLY. To give the exemption is not the answer to making sure you collect the money. Neither is giving a credit to a financial institution an answer to getting the money. Those are just things that were done by the Congress to try to save the impact of a bad piece of legislation that was passed and you say they're unable to do it. I don't know who we're talking about.

Secretary REGAN. Us, in the Treasury and the IRS.

Senator MATTINGLY. They are the IRS and they are the savings institutions or the saver, meaning that the way you get compliance is to make sure that the 1099's are coded correctly. That means that you institute a penalty upon this saver or the savings institution to make sure they do have the correct information on it by enforcing a stiffer penalty, not the infinitesimal penalty of $50 or $100. It may have to be $500 in order to do that. And what I'm saying is a long time ago when we first began this vicious circle saying let's search for a better way to do it, a better way to do it is by creating compliance, by making sure people use the correct I.D. number and the correct social security numbers on the 1099's.

I would hate to think that—all the arguments that I have heard in the last probably 60 days or 90 days have been "We hate to lose the revenue." I've heard that on the floor of the Senate. Well, that's not the answer to proper compliance. The answer to proper compliance is a better way to handle it. And having spent 20 years and 5 months with the IBM Corp., I don't want to throw out names of companies, but I can assure you that this type of company can figure out a better way of compliance than this. I think it needs to be clear to the American people once again that if we're trying to get the $1.5 billion that is owed, why are we taking $4 billion?

Secretary **REGAN**. As you know, having worked for the IBM even if we had IBM come in today with the most sophisticated instruments and write the software for this program and debug it we're talking about 1990 or 1992. The IRS has computers that are 20 years old. We have some computer operators that are younger than the machines they're operating.

Senator **MATTINGLY**. Maybe if we hadn't hired those 2,800 students last year we'd be able to afford to buy some better equipment.

Senator **LAUTENBERG**. Or service, if you don't mind. You can by it through service companies.

Secretary **REGAN**. At the current time we're trying to do both.

Senator **MATTINGLY**. Why don't we increase the penalty for the savings institutions and the savers and put a moratorium on that unfair piece of legislation we passed last year maybe for 3 years and see if we can't get better compliance?

Secretary **REGAN**. That might be more expensive for the institutions than doing it this way because—you mentioned the $1.5 billion—for a small institution, it would cost several thousand dollars to put in such a system. If they made 10 mistakes over the course of a year, they're probably already spending more than this program will cost them to put in.

Senator **MATTINGLY**. This is not a perfect society and you'll probably never get all the money even if you had withholding, but when the people are against it and the Congress is against it, maybe something is wrong.

Secretary **REGAN**. I'm convinced that if the people and the Congress really understood the issue and really looked at it and didn't have this misinformation that's been bandied about——

Senator **MATTINGLY**. I think we're down to a minor number of people who don't understand the issue and they're not the people in the country or the people in the Congress. Thank you very much.

The **CHAIRMAN**. Let me just ask one question about withholding. I did not intend to bring it up today.

Secretary **REGAN**. I rather suspected somebody would, Senator.

The **CHAIRMAN**. We will discuss it fully starting on the 15th of April again.

Senator **MATTINGLY**. This is just a warmup.

The **CHAIRMAN**. But until very recently all of the Treasury and agency obligations, savings bonds, jumbo CD's, and all of those bearer instruments, they didn't have any of the requirements that were imposed. In other words, the Government was not doing—the old case of do as I say, not as I do.

Do you have any estimates on whether a lot of the people in this 11-percent noncompliance group have never been used to being checked on, 1099's or anything else in that area, and they're continuing on in that mode rather than the deposit account?

Secretary REGAN. Offhand, I don't have an answer on that but I would be more than willing to find it and give it to you for the record, Senator. We are going to put in these programs at Treasury to collect and withhold. But as to what the area of noncompliance is, I'm not sure the IRS has the information on this. If there is such a study, I will make it available to you.

The CHAIRMAN. I don't either. I'm just curious. It always bothers me when the Government requires the private sector to do something that the Government is not willing to do themselves.

Secretary REGAN. I would want the Treasury to be doing exactly what we are requiring of banks and other corporations and if they are withholding we'll withhold.

MCFADDEN PROHIBITION ON INTERSTATE BANKING

The CHAIRMAN. Let me get back to McFadden. I don't think a lot of people understand that McFadden is a national law, but McFadden has never prohibited individual States from agreements, compacts between them, and so in response to Senator Mattingly, you said you didn't think relaxation on a metropolitan or regional basis or contiguous State basis would be helpful, but we've got situations like the New England experiment. At least they're talking about six States in New England. And that certainly complies with McFadden, if they desire to do that.

I have taken the position that if individual States want to go ahead on that basis, regional market areas and things of that nature, that is fine with me. What's wrong with that? Say the six New England States as an example decide to do that and it works out well and we decide later on to ratify that situation and say that sounds like a good idea for the whole country. I just want to draw you out on whether you're just saying you don't think it's a good idea for us at the national level, at the congressional level, to start with regional experiments.

Secretary REGAN. As you recall, Senator, last year I did suggest that interstate branching in at least the metropolitan area of contiguous States be permitted, whether or not at the national level, and whether or not the States had reciprocal agreements. But then I find a lot of banks saying to us, "Well, that may be fine about our getting into the next State but we would rather be in several States," and since a broker can now go from State to State or an insurance company can go from State to State with no trouble, why shouldn't a bank be allowed to do it?

That's what led me to think that we should start nationally rather than just regionally.

The CHAIRMAN. Well, I understand that. My question is, do you have any objections to the States operating legally under McFadden?

Secretary REGAN. Oh, no, absolutely not.

The CHAIRMAN. Before we get to the point of making that decision, whether that's the way we want to go or not?

Secretary REGAN. No. I think that if the New England experiment works, fine. I'm all in favor of that. But I do think that Congress is going to have to come to grips with the issue because the plastic card is going to undo the Congress. It's possible right now to draw money in one State thousands of miles away from the home State of your bank. If that isn't banking, what is banking? If you can do that, you can also deposit money. Well, the next thing you know you'll be able to make a loan that way through a CRT device hooked into your bank, again crossing State lines.

So I think the Congress has to realize, with the State of the art being what it is and what it may be in the near future, that the Congress should permit interstate banking on more than just a contiguous State basis.

The CHAIRMAN. Well, there's a lot of things that Congress needs to come to grips with. I won't take the time now to talk about it. Political realities are such that they won't come to grips with McFadden quickly. The cans I opened up with S. 1720 are rather minor compared to McFadden and Glass-Steagall. And I agree with you. You've heard my speeches. Interstate banking is already here. There are interstate trust operations. There are interstate loan generation offices. There are grandfathered institutions like First Interstate operating in 11 Western States and you've got Northwest Bank Corp. out in Minneapolis. Interstate banking is already here, but the public and the small institutions of this country are not willing to accept it and neither is Congress and there simply aren't the votes to do it. If I announced today that I was in favor of repealing McFadden, I might have 10 or 12 votes to go with me in the Senate. I don't know. Maybe not that many. So the political realities are that no matter what's happening with plastic cards and electronic funds transfers, Congress is not ready to do that. It took us 2 years with my bill. Certainly these issues are going to take at least that long to come to some resolution. So my statement was simply that if individual States legally under the law decide to make decisions, it isn't for me to tell them to do so or not.

I was speaking before the Connecticut bar a few weeks ago and a question came up about the New England experiment and what was my opinion. My opinion was simply that if six State legislatures can get together and make that kind of determination, that's their business, whether I agree with them or not.

My point is simply in the meantime, while Congress struggles with the national issues, if individual States want to change McFadden on a compact basis, on a bilateral or multi-State basis, I think they should be allowed to go ahead.

Secretary REGAN. Oh, yes, definitely. I agree with that, Senator. I would also suggest that if the Congress won't take the full step that a half step is better than none. That is, allow interstate banking either in metropolitan areas or contiguous States, if it is not allowed by the Congress on a national scale. In other words, I would like to see something done because the regulators are having trouble defining what's going on and what they can and can't permit. If Congress won't come to grips with it fully, you've got to expect end runs around existing legislation.

The CHAIRMAN. I can't tell you how fully I understand the problem and I will do everything I can, as I did the last 2 years, to try and push Congress to come to grips with making these decisions, whatever the decisions are, without prejudging them. That's why I wanted to start this process over again and at least expose all of the issues, first of all, in general oversight hearings without specific legislative issues to comment on, but that will come as a result of these hearings. There will be proposals no doubt, as with Senator D'Amato asking for specific recommendations. We'll get down to detailed hearings on all specific recommendations and hopefully over the next couple years can come up with another bill that will rationalize some of these problems. In the meantime, I just want to make a point that I'm not going to interfere with States if they can be more progressive and move more rapidly than the Congress. I think everybody now accepts NOW's and Super NOW's nationally. That started with the New England experiment and maybe if the States had not been willing to push into some of those new frontiers Congress would never have acted. I sort of feel that it takes outside happenings to force Congress—all of the lecturing back and forth between you and I or between an administration and Congress doesn't seem to have nearly the impact that some outside happening does. We probably would not have had the Garn-St Germain without the Secretary of the Treasury who in his former life—as we were talking about former lives—invented CMA's and things of that nature. That was an outside happening that forced Congress to produce insured money market accounts and you were both at the birth and the marriage or whatever we want to call it, at both ends. Senator Lautenberg, in his experience—I don't know what birth or marriage or death he's going to be at in the future—but I think it's the marketplace that will force us finally to come to grips with these problems.

Unfortunately, the marketplace changes so rapidly now it's almost on a week-by-week basis. It isn't months or years any more. The technology is developing so rapidly and that's where I feel a great sense of frustration in how rapidly it's possible to move Congress. If we were 10 or 12 or 15 years behind the power curve before Garn-St Germain, we're probably 6 or 7 years behind now. We didn't even catch up, and yet there's still rumblings that we moved too rapidly with that, but we're still behind and dropping more and more behind every day.

Senator crops

Senator Lautenberg.

Senator LAUTENBERG. Thank you, Mr. Chairman.

Mr. Secretary, I know we're not going to continue this discussion on taxes and withholding, but would it be your judgment that calculations on daily interest—Super NOW's, NOW's, transfers within accounts, trust accounts to commercial accounts and so forth—is considerably more complicated than a 10-percent deduction with allowances made for exemptions?

Secretary REGAN. Very definitely. Certainly.

Senator LAUTENBERG. Therefore, it doesn't look like it's truly too great a strain on the system, does it, to make a very simple 10-percent calculation?

Secretary REGAN. Senator, there are several banks that already have their software in place and are ready to go right now, and more and more each day are reporting the same thing. They found it's not an easy problem, but it is not an insoluble problem either.

Senator LAUTENBERG. I think you might be able to get that software at Radio Shack or someplace like that. It's that common.

I do understand why it is not a simple match-up process in IRS. The requirements of the system have far outgrown the update of the system. As far as I'm able to determine, we have not been able to make the appropriate investment in updating the IRS system.

Secretary **Regan**. That's the unfortunate part about it. The IRS has not been able to update its equipment. We are now in that process, but we are way behind the curve.

Senator **Lautenberg**. There was a different manufacturer's equipment, I thought that was put into IRS.

Secretary **Regan**. It was.

GOVERNMENT NEEDS CASH FLOW

Senator **Lautenberg**. The fact is, though, that the employer today doesn't get any real credit for deducting withholding from wages, assembling that information and reporting it at year end. They manage to do it without burdening the system too much. And the one thing that I fail to understand is why isn't it just as essential for government to have the cash flow to keep up the expense side as it is for individuals or companies. Wouldn't you agree that the Government has to have a constant source of funds? Otherwise, they're in the marketplace borrowing against the private sector?

Secretary **Regan**. Oh, yes. For cash management purposes we have to have a regular weekly cash flow and we have to know what it is and anticipate when borrowings are needed or when we will have a cash surplus. So we go through that very carefully at Treasury. The collection of taxes on a regular basis is already being accomplished for a great portion of our taxes through estimating, and anyone who estimates should not be upset by withholding because they merely adjust their estimation on a quarterly basis.

One other thing we have permitted is that deductions for withholding be made only once a year and at the end of the year. That inconvenience is very small for either the institution or the customer of the institution. It merely means that tax is collected in December and sent to the Government in January rather than the person's returning that same amount with his return in February, March or April. So again, I don't see why this outcry.

Senator **Lautenberg**. I'm inclined to view it the same way and the question is, whether it has good economic purpose or it hasn't. It's certainly not to be determined by whether or not the recordkeeping is complicated because our whole world is complicated by recordkeeping.

To get back to the regulation side of things, why is it necessary at this point to change the structure further, in your judgment? I know you went through it essentially in your testimony, but you know the old adage about if it's not broken, why fix it?

MEETING NONFINANCIAL INSTITUTIONS HEAD-ON

Secretary **Regan**. I think it is broken. I think that's what has happened here. I think that the playing field is not level, if I could put it in a hackneyed phrase, for this reason: there are many nonfinancial institutions that are making end runs around the banks and the banks have to sit there, a very, very much regulated industry, with people coming into banking or phases of banking or on the periphery of banking not having the same regulation.

What I'm trying to do, and I think the committee should try to do, is to try to level the field. I think that if the public wants financial institutions to provide more than one service, then the public should be given this right through legislation. If a bank chooses to try to go into other fields to expand its activities, that choice should be left to the bank, rather than denying that right to the bank but permitting it to others that are not banks. Banks now have to test the ingenuity of their lawyers to find out how they can get into other fields without violating a law. All I'm saying is that the time has come for change. We are much closer to the 21st century than we are to the 19th century, yet our banking laws are a reflection of the 19th century and the experiences that we had in the early 20th century. We have to start thinking in terms of how the financial services industry is going to look 15 or 20 years from now and into the 21st century.

What I'm suggesting is that the Congress start preparing for that now through legislation rather than trying to play catchup in the years ahead when the whole industry may be in a shambles. It's going to be very difficult at that time to sort out the players or make laws that make any sense. I think now is the time to do it. We are emerging, thank goodness, from a recession. The banking industry—at least the commercial side of it—is reasonably profitable. The brokerage firms are very profitable. What better time to do it than now? If you wait for crisis and do it as Glass-Steagall, after the fact rather than before the fact, you may regret it.

I would rather see the Congress take the initiative now and meet the problem head-on at this time rather than wait.

Senator LAUTENBERG. When we have the kind of velocity and change that the chairman discussed, doesn't that suggest that this is the time for keeping an eye on things, with just a little better control? Instead of further opening the flood gate?

One of the points that you make, Mr. Secretary—I think I almost quote you here—if not, I think I gathered the context very clearly—is about people coming in and siphoning off parts of the banking business; they are ill-equipped, without the proper knowledge. As I understand your view, you're saying: permit the banks more freedom instead of regulating those who are coming in, instead of saying, now wait a minute, you can't come in here except with certain qualifications.

Do I summarize your view?

Secretary REGAN. I agree with you that the banks should be permitted to do other things, but I believe the people who are coming into the fields of banking should be regulated in exactly the same way that the banks are now regulated. In other words, there should be even regulation. In speech after speech I've used the expression "football." What does football mean? Well, if you talk to an American you get one definition of it. If you talk to a Canadian, you get a different definition—110 yards, 12 players. Say football to an Englishman, you get still a third definition.

MAKE BANKING RULES SAME FOR EVERYONE

Now we talk about banking. What is banking?

You get not only three definitions of banking; you'll get about 300 versions of what banking means. I think it's up to the Congress to make up its mind what banking is and how banking should be regulated and then to make rules and allow anybody to enter that wishes to enter.

Senator LAUTENBERG. OK, but you said, make the rules, define the playing field, etc. That speaks to regulation, not to deregulation.

Secretary REGAN. Deregulation in the sense that you allow entry by anyone into the business, but then after they're in the business, regulate them evenly.

Senator LAUTENBERG. So you're speaking for ——

Secretary REGAN. You see, to go back to the Business Week article, the wall is up that doesn't permit ease of entry. What I'm suggesting is make the ease of entry the same for anyone who might get into the computer business if he desired. What I'm saying is that because of the uniqueness of banking, once banks are created then there should be specific regulation for them, and specific regulation of the other fields of finance. Insurance is a field of finance. That should be regulated differently than banking. Real estate is part of finance. It should be regulated differently than banking. Securities is finance. It should be regulated differently than banking. But yet permit all of those services under the roof of one financial institution.

Senator LAUTENBERG. The holding company?

Secretary REGAN. Yes.

Senator LAUTENBERG. Again, I've got my friendly reminder. I don't know whether you said in your remarks "anybody can get into the computer services business." Now I want to draw the line someplace. Thank you, Mr. Secretary.

The CHAIRMAN. Senator Mattingly.

Senator MATTINGLY. I won't ask you about withholding again. One last question, or statement maybe. We're trying to describe what a bank is. Maybe we shouldn't be trying to describe what a bank is. Maybe we should be trying to determine what financial services are. Obviously, in trying to describe a bank becomes so complicated that you're going to get more ideas and more input about what a bank is. Maybe we're searching after the wrong thing.

Secretary REGAN. Well, you will have to come to grips with that question in the bank holding company discussions because we're suggesting in our legislation that the bank holding company be permitted only to engage in financial services.

Now the computer field obviously is not a financial service and we're not suggesting that other forms of commerce that are nonfinancial be permitted under the Bank Holding Company Act.

Senator MATTINGLY. Well, since we're not going to ask any more questions about the 10 percent—I won't even refer to it as a tax—withholding.

Secretary REGAN. Remember, it's not a new tax.

Senator **Mattingly**. I know. I've never referred to it as a new tax. I just called it that for conversation. Thank you very much.

The **Chairman**. Mr. Secretary, as usual, you've been very articulate and well-informed and this is, as I said several times, the beginning of a process that will take some time. We will follow up with as many as 8 or 9 or maybe even 10 days of general oversight hearings from various witnesses. Then from those, start to condense down and have more specific hearings on particular ideas, hopefully then coming up with legislative proposals in all of these areas.

So I appreciate very much you being the leadoff witness and we look forward to working with you in this process and hope that it can be concluded successfully as our work over the last 2 years was.

Secretary **Regan**. Thank you, Mr. Chairman. Thank you for your courtesy. We stand ready at Treasury to work with you.

The **Chairman**. Thank you very much.

The committee is adjourned.

[Whereupon, at 11:30 a.m., the hearing was adjourned.]

FINANCIAL SERVICES INDUSTRY—OVERSIGHT
Part I

TUESDAY, APRIL 26, 1983

U.S. Senate,
Committee on Banking, Housing, and Urban Affairs,
Washington, D. C.

The committee met at 9:30 a.m. in room 538, Dirksen Senate Office Building, Senator Jake Garn (chairman of the committee) presiding.

Present: Senators Garn, Heinz, Gorton, Hawkins, Hecht, Proxmire, Riegle, Dixon, Sasser, and Lautenberg.

OPENING STATEMENT OF CHAIRMAN GARN

The Chairman. The Banking Committee will come to order.

Today we are continuing the oversight hearings on the condition and structure of and competition within the domestic financial services industry which were begun a couple of weeks ago with the testimony of Treasury Department Secretary Regan.

I believe the ideas which were exchanged that day between the Secretary and members of this committee provided a good foundation for the testimony that will be received today and tomorrow and for representatives of the depository institutions trade organizations who have been scheduled to appear next Tuesday and Wednesday.

I am pleased to welcome the Chairman of the Board of Governors of the Federal Reserve System, Chairman Volcker, to these hearings today, and heads of the other four Federal financial institutions supervisory agencies will be appearing tomorrow. We certainly look forward to all of their testimony.

Just as a reminder, the purpose of these hearings is to gather information on the current status of the financial services industry as well as to explore ideas for the future direction of that industry. Therefore, we welcome the discussion of any and all issues relevant to such an undertaking.

Senator Proxmire.

Senator Proxmire. No statement.

The Chairman. Chairman Volcker, would you like to proceed?

STATEMENT OF PAUL A. VOLCKER, CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. Volcker. Mr. Chairman, let me say first of all that we greatly welcome your initiative in undertaking these oversight hearings. There are a great many issues that need to be dealt with and resolved and I was very conscious, in writing my own statement, of the breadth of the subject matter that's involved. I won't attempt to read the lengthy statement, but let me just highlight a few points.

[Complete statement follows:]

Statement by

Paul A. Volcker

Chairman, Board of Governors of the Federal Reserve System

We in the Federal Reserve welcome your initiative in undertaking these hearings to review, from a broad perspective, developments in markets for banking and other "financial services," laying the groundwork for future legislative initiatives. There can be no doubt that a reexamination of the existing legislative framework has become urgent. Our financial system has been evolving rapidly in recent years. Much of the change is a constructive response to technological or market pressures and the opportunities made possible by deregulation. But it is also clear that the process has been rushing forward with little conscious sense of some of the broad public interests at stake -- the need to maintain a safe and stable financial system, to assure equitable and competitive access to services by businesses and consumers, and to preserve an effective mechanism for transmitting the influence of monetary, credit and other policies to the economy.

Many of the laws intended to guide and shape the development of the financial system were enacted under far different circumstances. They may or may not serve today's purposes, and in some instances may themselves be a source of distortion, competitive imbalance, and weakness. For all these reasons, I appreciate the opportunity to set forth some general considerations that we in the Federal Reserve feel are relevant in assessing particular legislative proposals. At a later time, we would, of course, be prepared to set forth more specific suggestions.

The Current Situation

The accelerated pace of change in the structure of our financial system in recent years has reflected both irreversible technological as well as market forces. The low cost and speed of data transmission, communication, and personal transportation have vastly enlarged the market reach of banking and financial institutions. The technical capabilities of providing a variety of essentially computerized financial services are broadly available. At the same time, the number and wealth of potential customers have multiplied, and with them a demand for a greater array of financial services and more sophistication in seeking out maximum returns. Diversification of investments beyond traditional deposit accounts, ready access to sources of borrowing power, and the flexibility to change financial strategies rapidly and inexpensively have become increasingly important.

Several other factors affecting the financial environment have also provided impetus for change. Experience with inflation, and with sharply higher and fluctuating interest rates, has seemed to put a premium on financial manipulation, shifting funds rapidly to take advantage of changing yield relationships or perceived changes in the outlook. Institutions with embedded costs or fixed returns inherited from investment decisions made earlier have often been disadvantaged relative to newer market interests. In the new environment, regulatory restraints adding to costs (such as reserve requirements on the established depository institutions) or impairing quick responses to perceived opportunities (such as interest rate ceilings) have chafed more strongly, and distorted competitive positions. At the same time, the decades that have passed since any serious weaknesses in the financial system had been evident, a sense of security among depositors rooted in part in the knowledge of a strong governmental "safety net" protecting the financial system, and expectations of a persisting inflationary trend have all seemed to encourage less caution and a willingness -- deliberately or not -- for managers of financial institutions to undertake greater leverage and risk in the search for higher returns.

In combination, the technological and economic forces at work have led to a search for new financial services and for new ways to package those services, greater competition between traditional depository institutions and other providers or "packagers" of financial services, and a blurring in many of the traditional distinctions among depository institutions themselves.

One reflection has been the rapid growth of such relatively new institutions as money market funds and cash management accounts. Increasing efforts are being made, by means of mergers and otherwise, by securities firms, insurance companies, and others to exploit where possible perceived "loopholes" in existing law to cross traditional industry lines into banking and the payments system. Banks and other depository institutions have responded by bidding more vigorously for consumer funds and seeking, successfully, to ease regulatory restrictions. They have, to the extent permitted by law, moved to acquire security brokers, and to develop relationships with mutual funds. Moreover, some nonfinancial firms -- retailers or industrial firms -- have sought to enter financial markets, further eroding the traditional distinction in the United States between "banking," broadly defined, and commerce.

It is worth noting that, after decades of stability in the relative position of commercial banks in our financial system, more recent years have suggested some erosion. While that may well prove temporary, the sense of greater competitive pressures, the blurring of distinctions between banks and "non-banks," and the frustration about an unsettled and partly outmoded regulatory framework have certainly contributed to uncertainty about the future of depository institutions. Concerns of the thrifts have been even more pressing. In the past few years, thrift institutions carrying large portfolios of mortgages acquired at lower interest rates have been under particularly strong earnings pressure and their capital positions have sharply eroded. With their future prospects seemingly in jeopardy, the whole orientation of the industry is in flux, responding to immediate concerns as much as any carefully conceived vision of what role they should play in the future.

Whatever the merits of the process of change in responding to felt needs -- and they are considerable -- certain problems, actual and potential, have plainly emerged. As regulators and legislators concerned with the public interest, our task is not to thwart change or block responses to new needs, and institutions need to respond to market incentives. But we also want to see change channeled along constructive lines, sensitive to abiding and valid concerns of public policy. One of those basic concerns is the safety and soundness of our payments system and the financial system generally. Matters of competitive equity, both for the providers and consumers of financial services, need to be addressed. The consistency of emerging financial patterns with the needs of monetary and credit policy must be considered. And, historical concerns over concentration of financial resources and conflicts of interest in the provision of financial services should be reexamined for their applicability in the light of today's circumstances.

Unfortunately, the interaction between the current legal and regulatory structure and market pressures provides no assurance that these concerns are adequately addressed. Instead, in some ways it has channeled pressures for change in directions that have had unintended and adverse effects. Deposit-like instruments and payments services have sprung up in significant volume outside the framework of governmentally protected and supervised depository institutions. The depository institutions themselves have today a potentially more volatile structure of liabilities and smaller capital cushions than in the past. With the enlarged powers of thrifts, we now have competing "banking" systems with different legal and regulatory philosophies, providing incentives to exploit the most "liberal" (or "lax") provisions. Anomalies in the structure of our current regulatory system -- and challenges to long-standing regulatory interpretations -- are eroding traditional constraints on combining deposit-taking with other activities, in the process threatening to undermine whatever public interest may remain in those constraints.

The new vocabulary springing up of "non-bank banks," "thrift banks," money market fund "checks" -- seemingly inconsistent on their face -- reflect the blurring of traditional institutional lines and functions. Some of it is healthy, and some is not. What is needed is a broad look at the whole, with a period of public and legislative debate concerning the desirable ends and means, followed by a reshaping of the existing legislative framework.

Possible Interim Steps

As that process takes place, we cannot expect the market forces to stand still. But I believe we can and should deal, for an interim period, with some of the most obvious distortions and loopholes in the present regulatory structure that tend to channel change in specific forms that may in some instances be contrary to a desirable longer-term evolution. To that end, the Federal Reserve has broadened the definition of "commercial lending" to forestall, or limit, avoidance of the basic purposes of the Bank Holding Company Act. To the same end, I welcome the Comptroller's moratorium on new chartering of "non-bank banks" so that Congress has time to address the underlying issues. But clearly these measures are not sufficient to maintain even a limited "status quo," as indicated by the backlog of pending applications and, a subsequent announcement of an intended combination of a state-chartered bank and an insurance company and proposed combinations of thrifts and securities houses. Therefore, I would suggest that Congress consider limiting combinations of non-bank banks (and thrifts) with non-depository institutions for a strictly limited period of time so that you can decide on an appropriate policy approach rather than be faced with a fait accompli.

A similar, and possibly more serious, reordering of the national financial structure, without Congressional review and determination, is implicit in the recent actions and proposals in a number of states to allow the banks or thrifts they charter to engage across the country in a much wider range of financial and non-financial activities than banks or thrifts chartered by federal authorities. The motivation, in large part, appears to be a desire to compete for jobs among states, rather than careful consideration of a desirable evolution of the financial structure for the nation.

The federal concern in this regard extends beyond the fact that financial markets are increasingly inherently national in scope and the institutional setting has national implications. State-chartered depository institutions have federal support through deposit insurance and access to the discount window, reflecting the interdependence among banks and the national concern in their stability.

The Federal Reserve, in administering the Bank Holding Company Act, has for some years maintained a policy of permitting state-chartered bank affiliates of bank holding companies to engage in any activity such a bank is permitted to engage in under its State charter. This policy has been premised upon the view that a certain degree of experimentation and difference in approach among the states is a legitimate and desirable aspect of our dual banking system, and that differences in powers allowed by states would be acceptable to the extent they would not dominate established Congressional policy. In view of current developments, I believe that policy should be reviewed to consider whether the result is to undercut the federal standards set forth in the Bank Holding Company Act, particularly when the wider powers might clearly be exercised largely beyond the borders of the State providing the authority.

An Approach Toward the Regulation of Depository Institutions

In conducting a reexamination of the regulatory framework more generally, there are a number of general goals to keep in mind -- enhancing competition; promoting efficiency in the allocation of capital and credit; assuring protection of consumers, depositors, investors, and others against discrimination, conflicts of interest, and other potential abuses; and encouraging consistency and equity in the treatment of competing financial institutions. It's important to keep in mind that some of these goals will sometimes be best served by less regulation rather than more.

There is another consideration that has historically been of special importance in public policy toward banks and other depository institutions -- that is, plain, old-fashioned concern for safety and soundness. After decades in which the unfortunate experience of the 1920s and 1930s have receded in memory, there is a tendency to question the value of prudential concerns. But, as we approach regulatory reform, the old saying about the relative values of an ounce of prevention and a pound of cure is appropriate. Concerns recently expressed in this Committee and elsewhere about international lending, for example, amply demonstrate that the best time to think through appropriate approaches is before there is a problem.

Against that general background, the main lines of my own thinking about our approach toward the regulation of depository institutions can be summarized under four headings:

1. Banks perform a critical role in the financial system and the economy.

   Banking institutions, as operators of the payments system, as custodians for the bulk of the liquid savings in the economy, as essential suppliers of credit, and as the link between monetary policy and the economy, have a unique function in our economy.

2. The critical role of banks implies particular governmental concerns.

   Because of their role, the deposit liabilities of banks, and the stability of depository institutions generally, are protected to a degree by a governmental "safety net." The provision of that safety net requires and justifies a certain amount of prudential regulation and supervision to protect the government and public interest. The precise terms of this "compact," to assure efficiency, competitive balance, and sensitivity to new needs, should be reexamined periodically.

3. A bank cannot be wholly insulated from its affiliates. In the nature of things, parts of an organization under common management and, in public perception, related to each other, will, to some degree, be affected by the fortunes of other important parts. Consequently, concern about the activities undertaken within a bank holding company or otherwise within a consumer management structure is a natural and legitimate extension of interest in the safety and soundness of the bank itself. These activities may not require the same degree of supervision as a bank, need not be frozen in an historical pattern, and should be regularly reviewed in the light of economic changes and the desirability of maintaining a reasonable competitive balance.

4. The central bank has an inherent concern with the evolving financial structure. The core responsibilities of a central bank for economic and financial stability entail concern over the strength and stability of the banking

system, and the consistency of the institutional structure with the needs of monetary policy. Those concerns are appropriately and necessarily reflected in an on-going presence in the regulation and supervision of the banking system.

Banks and Their Regulation

The public concern with the safety and soundness of depository institutions has historically been related to the fact that they have been custodians of the bulk of the liquid savings of the country, a situation that still holds. That concern is interrelated with another pervasive public interest -- protection of the payments system. The individual components of the banking and payments system are, to a large extent, mutually dependent; adverse developments in one institution, particularly of substantial size, can dramatically and suddenly affect other unrelated institutions, some of whom may not even have a business relationship with the institution in difficulty. While secondary and tertiary effects are, of course, present in some degree in the failure of any business firm, seldom will the effects be so potentially contagious or so disruptive as when the stability of the banking system or the payments mechanism is at stake. Then, serious implications for overall output, employment, and prices -- indeed, for the entire fabric of the economy -- are apparent.

The first and most important line of defense is the interest of banking institutions themselves in maintaining the confidence of their customers. But long ago, in establishing the Federal Reserve System, the FDIC, and the FSLIC, the government determined that normal market incentives and protections needed to be supplemented by an official support apparatus. That support apparatus -- importantly reflected in access to the discount window at the Federal Reserve and to deposit insurance -- provides advantages in the competition for the public's funds. But there are offsetting costs as well in, for instance, reserve requirements and insurance premiums.

More broadly, the protection provided on the liability side of the balance sheet, in tempering the discipline of the marketplace, can potentially change attitudes and behavior over time with respect to risk-taking. Consequently, the logical extension of the public concern with the stability of the banking system is a continuing interest in avoiding excessive risk-taking, limiting the potential for contagious failures or drains upon the public "backstop" facilities. Those concerns are reflected in a number of restrictions and regulations on how banks (or thrifts) can do business, and the operations and assets of those institutions are examined periodically as part of a continuing supervisory process.

The practical and ongoing issue in this area, it seems to me, is not to revolutionize the basic approach, but to achieve an appropriate balance -- balance between desirable risk-taking and safety, and balance among competing depository and non-depository institutions. These considerations, for instance, are immediately relevant to the discussion by the Committee of the appropriate treatment of foreign lending and approaches toward assuring the capital adequacy of banks and thrifts.

One important area that is receiving attention is the appropriate structure of deposit insurance. The various insurance agencies have submitted reports to Congress suggesting ways to modify the current insurance system to achieve an appropriate balance of market and supervisory discipline; I have not reviewed those reports and cannot comment on them specifically. But I do welcome the process the Congress has set in motion to consider the public policy questions in this area, recognizing that deposit insurance has become such a significant element in the support apparatus for depository institutions that substantial change requires careful assessment of the possible consequences.

One corollary of the need to protect the integrity of the payments system deserves mention. In seeking an overall balance of protections and restrictions for banks, we can, and should, avoid competitive disadvantage to the depository institutions themselves; to do otherwise is to erode the vitality and strength of the very sector of the financial system deemed of special importance. To the extent that other institutions operating outside the "protected" framework nonetheless tend to "take over" the essential functions of banks, there are three alternatives:

we can encompass those institutions within the framework of banking supervision in some respects (such as reserve requirements on transactions balances); we can, if consistent with other objectives, relieve the regulatory burden (such as by paying interest on required reserves); or we can confine the performance of certain essential banking functions (such as third party payments and direct access to the clearing mechanism) to banks alone.

Bank Holding Company Regulation

In the framework of existing law and policy, concern with the activities of banking organizations has not stopped with the bank itself. The restrictions are importantly rooted in prudential considerations; experience strongly suggests the difficulty of insulating a bank from the problems of a company affiliated with a bank through a holding company. To be sure, the fortunes of the bank and its affiliates can be (and are) separated to a degree by restrictions on the transactions among them; section 23A of the Federal Reserve Act already contains a number of rules pertaining to such transactions. But I doubt the insulation can ever be made so complete -- at least without defeating the business purpose in the affiliation -- as to rely on those rules alone. The holding companies themselves, the securities markets, and the general public look upon these organizations as consolidated units. Our experience is that difficulties in a nonbank affiliate can affect the price and availability of funds to the bank (or vice versa), even if transactions between the two are controlled. The public realizes that a holding company with a troubled non-deposit subsidiary cannot be a source of strength to its deposit-taking affiliates, and will be under pressure to draw funds from the bank, directly or indirectly, to support other troubled operations. Moreover, while financial flows among affiliates can be circumscribed by regulation, management attention and expertise cannot be, and the more diverse the area of activity, the less attention the bank itself may receive at the top level.

Other concerns -- potential conflicts of interest and concentration of resources -- can also be addressed by law or regulation. But again, insulation is not likely to be complete.

At the same time, segregating certain activities of a bank holding company outside the bank itself may provide certain advantages. While it should not be assumed that, from a safety and soundness standpoint, the entities can be entirely insulated from each other, segregation may well make it easier to assure consistency and equity in the application of those regulations appropriate to particular activities conducted either in the bank or an affiliate. That consideration, for instance, could well be relevant in any extension of authority to bank holding companies to engage in securities underwriting, in mutual funds, and in insurance activities.

Regulations specific to such activities may not reflect certain of the prudential concerns of bank supervision; to that degree, non-banking activities conducted by banking organizations may have to conform to some rules that would not be necessary or appropriate for nonbanking firms. But there may also be advantages in combining certain activities with a banking license; when bank holding companies engage in non-banking activities we should seek to avoid competitive advantages arising from the ability to draw upon the implicit government support provided by the banking organization as a whole. One consideration in this regard is the capitalization of the non-banking activity; a higher degree of leverage in banking should not automatically extend to non-banking activities. Indeed, adequate capitalization of a bank holding company as a whole, taking account of the particular nature of the non-banking activities, is important to the safety and soundness of the bank.

In the end, the appropriate range of activities for a bank holding company should remain, in my judgment, a matter for determination by a balance of public policy considerations; it should not be solely a matter of market incentives, and some degree of supervisory oversight over the activities of the holding company as a whole will remain important. The traditional presumption that there should be some separation of banks from businesses engaged in a general range of commercial and industrial activities, and vice versa, still seems to me a reasonable starting point in approaching particular questions. That separation is, at the margin, arbitrary, but in a broad way it reflects continuing concerns about risk, conflicts of interest between the bank as owner of a nonfinancial firm and as creditor, and the implications of excessive concentration of economic power, especially given the central place of banks in our economy. Moreover, to the degree that affiliation with a bank implies the need for some regulatory or supervisory oversight, practical and desirable limitations on the reach of such regulation into industrial and commercial activities implies some limitation on the scope of bank holding company affiliations.

Within this general framework, the precise line dividing what ought to be permissible for banking organizations to do and what should be proscribed does need reexamination in the light of current market conditions, changes in technology, consumer needs, and the regulatory and economic environment. Some activities now denied banks would seem natural extensions of what these institutions currently do, involving little additional risk or new conflicts of interest, and potentially yielding significant benefits to consumers in the form of increased convenience and lower costs. For some time, for instance, the Federal Reserve has suggested that banking organizations be allowed to underwrite municipal revenue bonds, establish comingled investment accounts, and distribute mutual funds. Certain brokerage activities have already been approved within existing law, as have a wide range of data processing services.

Other activities seem ripe for consideration, but need a public airing of views and Congressional consideration. One general category would be further extension of brokerage activities related to the financial needs of bank customers, including sales of a variety of real estate, insurance, and travel products. Some kinds of insurance underwriting, beyond current limitations to credit-related insurance, have been urged by some.

Other activities that have been discussed raised considerably greater questions in my mind because of factors of risk or conflicts of interest that could not be contained without the most elaborate and self-defeating kinds of regulation. Corporate securities underwriting, real estate development, and, more generally, significant equity positions in unrelated non-financial activities fall into that category.

In any event, to the extent that regulation is needed, the goal should be to minimize the costs and burdens of regulation consistent with the public interest. For example, experience has convinced us that the present statutory requirement for public hearing in the Bank Holding Company Act sometimes leads to unnecessary delays in the processing of applications. This requirement could be modified to relax the requirement for public hearing, while retaining discretion for the Federal Reserve Board to conduct informal hearings in cases where public comment is warranted, This change alone would reduce significantly the time required to process some applications filed under the provisions of the Bank Holding Company Act. Also, the statutory requirements for approval of nonbanking activities could be modified to place greater emphasis on safety and soundness and less emphasis on the finding of net benefits, and provision could be made for the Board to follow more expedited procedures in the processing of applications.

Consistency in Bank-Thrift Regulations

The observation that thrift institutions have essentially become bank-like institutions is indisputable with respect to the powers they are allowed to exercise; it is increasingly accurate with respect to the powers they do exercise. But questions are posed not just by the fact that thrift powers have been expanded to matters previously the province of commercial banks alone; in important instances thrift powers extend well beyond those available to banks. Considerations of competitive equity alone would seem to dictate that the special privileges and restrictions of banks and thrifts be brought into more coherent relationship.

The significance goes beyond equity considerations. In today's world, the kind of consideration I just reviewed with respect to the powers of banking organizations, flowing basically from banks' participation in the payments mechanism, cannot be valid for commercial banks alone; limitations on bank holding companies could not be effective to the extent thrift instititutions, with the corresponding banking powers, could simply substitute as a vehicle for combining various activities. I recognize there are difficult questions posed by the firms that already have operations on both sides of the line between commerce and thrift banking, but we will need to find some way to resolve these questions and establish a firmer policy for the future if we are to bring about a rational structure in this regard. The same consideration bears upon a number of other issues --

particularly branching and interstate powers -- where the differences between regulatory treatment of banks and thrifts has become increasingly anomalous.

The implication is not that all thrifts and their holding companies must be regulated in all ways like commercial banking organizations. There may well be ways of distinguishing among institutions, depending on the scope and extent of their actual activities, which would allow us to achieve necessary functional consistency and assure the integrity of our policy intent, while retaining the advantages of a degree of specialization among financial institutions. As I understand it, the Congress had such concerns in mind in linking the more liberal treatment of unitary savings and loan holding companies in important respects to satisfying a certain asset test originally developed for tax purposes. However, that asset test -- the proportion of an institution's portfolio in real estate mortgages, government securities, and certain other "qualified" assets -- seems to me inadequate for the purpose. The interest of investment companies and other non-banking firms in acquiring savings and loans suggests that such an asset limitation would not deter substantial non-bank participation in deposit taking and payments services.

Federal-State Relations

For over a century this country has maintained a dual system for the regulation and supervision of banking. On the whole, this dual banking system has played a useful and constructive role in encouraging innovation in the financial regulatory environment and in helping to accommodate local differences in the needs of banking organizations and their customers.

The system worked as well as it has because to a significant degree the goals and techniques of regulation were commonly shared, and the divergences between federal and state treatment were kept within tolerable bounds. As I mentioned earlier, this comity appear to be breaking down, as states consider vast expansions of powers for banks and thrifts that go far beyond standards allowed by federal law and yet still rely on federal protections for their state-chartered institutions. The issue will need to be addressed by the Congress as to whether it is properly a federal prerogative to establish the outer bounds within which the dual banking system may continue to be a useful and constructive force.

The geographic scope of depository institutions has long been a key question of federal-state relations. The proliferation of nonbank affiliates of bank holding companies operating across state lines, the loan production and Edge Act offices, the integrated national markets for money and credit at the wholesale level, the current action of some states themselves to permit entry of out-of-state banking organization, the broadened power of thrift institutions able to operate interstate, and the credit card itself have by now led to interstate banking de facto for most banking services. But, as a general matter, we still prohibit on an interstate basis that portion of retail banking and some other services that require a brick and mortar presence, and we force other activities into "unnatural," and less efficient, channels.

I believe your deliberations will need to consider whether the time has come to rationalize this situation. Appropriately structured, banking across state lines can increase competition for the delivery of financial services and by so doing should enable users of these services to obtain them at lower cost and in a more convenient manner. Indeed, broadened geographic scope can even serve to reduce risk to the banks themselves, and perhaps reduce pressures to extend their franchise to less suitable areas of activity. I recognize the controversies and sensitivities surrounding the McFadden Act and Douglas Amendment. I also know there are a number of approaches that could be taken in easing or removing those restrictions; a period of transition may still be useful. Indeed, I am encouraged that some states have already chosen to take the lead. But I sense the time for Congressional review of the issue is here.

Regulatory Structure

The rapid evolution of the financial system inevitably raises new questions about how the government's role in regulation should be organized and implemented. As you know, this subject is being reviewed by a Task Group under the leadership of Vice President Bush, on which I participate. Without going into any detail on the pros and cons of the many different ways the regulatory agencies could be organized, I do want to comment briefly on the implications, as I see them, for carrying out the basic responsibilities of the central bank for the strength and stability of the financial system.

The argument has sometimes been put forward that supervision and regulation of the banking system can be divorced from monetary policy, and that the Federal Reserve ought to stick to the latter. That argument is premised on a view of monetary policy and inherent Federal Reserve responsibilities that seems to me far too narrow; pressed to its logical conclusion, both monetary policy and supervision would be gravely weakened. The basic objective of the Federal Reserve -- and the principal reason for its very founding -- is to contribute to a stable and smoothly functioning financial system, one that is capable of supporting and responding to the financial requirements of the nation under a variety of circumstances. Out of those concerns, the Federal Reserve Act explicitly provided the Federal Reserve with both an operational role in the payments mechanism and wide supervisory authority, and I believe those concerns remain valid today.

Over the past 70 years of the Federal Reserve's existence, the specifically monetary policy function -- explicit attention to control of the total supply of money and credit and stabilization policy -- has been developed and refined. But monetary and credit policy works through the banking and payments system and the individual institutions within it; in the last analysis monetary policy cannot be successful independent of the strength and resiliency of that banking system. Conversely, history is filled with examples of a breakdown in the banking system overriding, in its adverse economic consequences, the effects of more general policy instruments.

The interrelationships are not theoretical; they are embedded in our daily operating experience. A key "monetary policy" instrument is the administration of the discount window, through which we advance funds to meet temporary liquidity needs and can act, if necessary, to meet our responsibilities as lender of last resort to the financial system and the economy as a whole. By its nature, provision of funds through the discount window presumes an intimate awareness of the circumstances of the particular borrowers, skill and experience in financial analysis, and a degree of supervisory authority.

More broadly, the Congress and others, quite properly and understandably, look to the Federal Reserve for advice and, when necessary and possible within the framework of our statutes, for action in dealing with points of immediate financial strain and crisis. But those responsibilities seem to me to entail a continuing responsibility for participation in the regulatory structure, "hands on" supervisory capability, and a strong voice in the evolution of the banking system.

Moreover, monetary policy, as more conventionally defined, needs to be conditioned by circumstances as they exist in the financial world. A financial system that is too fragile, for example, might constrain our flexibility to pursue certain goals -- most especially that of combatting inflation. More general tendencies in the financial system -- such as the shift toward increasingly liquid assets in recent years -- can affect the behavior of money and other policy indicators that we rely upon in conducting monetary policy, and in some cases could have destabilizing effects on financial markets and institutions.

None of this dictates a particular regulatory structure; indeed, there are areas of regulation or supervision of only peripheral interest to our central responsibilities. But we do feel that a continuing role in regulation and supervision is an inherent part of effective central banking.

Mr. VOLCKER. In essence, you have quite appropriately asked for a review of much of the body of existing banking law and for us to get into a great many issues that have been very sensitive through the years relative to the treatment of depository institutions and that touch upon Federal-State relationships in this area, the powers of banks and banking organizations, the focus of regulatory authority. I recognize these are all difficult issues, but I don't see how they can be avoided at this point because the situation is extremely fluid—in some respects almost chaotic—in terms of the developing institutional change in the banking and financial area.

I think much of that change is, and will turn out to be, healthy, as a response to evident needs, as a response to competitive pressures. But it's certainly also proceeding without a sense of clear direction in terms of public interest and public policy. Much of the change is channeled in particular directions because of legal loopholes or distortions; I think there is an urgent need to sort out where we want to go, what's good about the current change and what isn't, to make those distinctions.

AREAS OF PUBLIC INTEREST AT STAKE

My statement is not directed as much to specifics as you requested but to more general policy concerns and regulatory philosophy. There are a great many areas of public interest that are at stake here—competition, efficiency, delivery of services to consumers. We emphasize some points from a particular regulatory perspective that I might just refer to briefly now.

Our point of departure is that banking is especially affected by the public interest. That's not a very startling statement. In terms of the history of the country, that's always, I think, been a basis for regulation in this area. It's true perhaps particularly because banks are custodians of the payment system, and the many interdependencies in that area require a degree of public oversight. There are the dangers of contagion, secondary effects of failures in the financial world generally, but particularly in the banking system, have always been of concern. This country, throughout its long history, has had plenty of experience with banking difficulties and their adverse repercussions when you don't have effective public policies in this area.

It immediately follows from that point that banking, broadly speaking, has been the beneficiary of certain protections, a kind of public safety net is drawn around the industry that's important and brings competitive advantages to the banking system. The other side of the coin is that banks are regulated and supervised, and we assume that kind of broad tradeoff will continue. It raises continuing issues of maintaining an appropriate balance between protections and regulations, between necessary protections and necessary competitive freedoms.

The third point we emphasize is that while we believe it is possible for banks to engage in activities beyond the narrow area of banking, we do not think in the end you can really expect activities engaged in by a single organizational entity—namely, a bank holding company—to be completely insulated from each other. You can take some steps to try to insulate them in various parts of the organization, but an organization operating under common management is going to be in a situation where the fortunes of one part influence the fortunes of another part. That fundamental fact seems to us to bear upon types of activities that bank holding companies should be permitted to engage in and the degree of regulation of the different activities brought under the single organizational framework. There is considerable discussion in my statement as to some of the implications of that point.

The final general point we make is that in approaching this subject we do believe that the Federal Reserve, like any central bank, has a continuing and abiding interest in banking supervision and regulation because in the end it has to be concerned about the stability of the banking system and the stability of the financial system in the broader sense. If you go back to history, that's really why the Federal Reserve was founded, and I find the distinction that's sometimes made between monetary policy and regulatory policy wholly artificial in that connection. Monetary policy couldn't operate in a vacuum. It operates through a financial system, through a banking system; and, in terms of our responsibilities of lender of last resort to individual institutions or, more broadly, to the economy generally, we have to have a concern about the condition of the financial system and its individual parts. So I think that does have implications for the distribution of regulatory authority and the fact that the Federal Reserve should have some presence in that area.

I would also note that there are some rather urgent interim problems that have developed and that the Secretary of the Treasury, in his testimony to you also pointed up these problems. We have the so-called nonbank bank phenomenon which is being used to expoit certain loopholes—if in fact they are there—in the framework of the Glass-Steagall Act and otherwise. We have the problem that I think of as "bank-thrifts"; thrifts have not been subject to some of the same restrictions as banks or bank holding companies, yet they now essentially have banking powers, which raises an area of actual and potential distortion. Some administrative actions have been taken to reduce those distortions, both by the Federal Reserve and by the Comptroller of the Currency. At this point I have to conclude, however, that legislative action may be necessary so that the Congress, in its considerations of more fundamental reform, is not faced with a fait accompli in some respects.

The other area in which events are racing ahead of congressional consideration is the action by a number of States in providing new and sweeping authority to banking organizations that far outpace anything that's provided under Federal law. I think that that is an area that deserves both administrative review and potentially congressional review in the short run. What I am thinking of, in very general terms, is a kind of standstill while Congress sorts out the directions in which it wants to go—a standstill that would be strictly limited in time.

You do face a very large agenda. I sense that in some respects my own views on some of these matters may be characterized as more conservative than some others. I'm not about to apologize for that orientation. I think the effective operation of the financial system and its stability depends upon a sense of confidence. It depends upon a sense of its safety and soundness. We're inclined to forget how important that intangible is until it's not there, and I do think that has to be a centerpiece of concern—confidence and safety and stability—in public policy in this area.

That's all I would want to say initially, Mr. Chairman.

The CHAIRMAN. Thank you very much, Mr. Chairman, and your entire statement will be placed in the record.

May I ask my colleagues who were not here at the outset if they have any opening statements they would like to make before we proceed with the questioning?

[No response.]

The CHAIRMAN. Mr. Chairman, let me ask you a question which was really apart from today's testimony before we get into the oversight part, something that this committee has been struggling with for several weeks now, and that is the IMF fund increase.

INTERNATIONAL DEBT CRISIS OVER?

There was an editorial in the Wall Street Journal today and I don't know whether you've seen it or not, but it says, in summary,

> It appears to us that the international debt crisis as conventionally defined is for all practical purposes over. If the crisis really does exist the IMF is sitting on about $45 billion of gold that could be pledged to raise more than enough hard currency to deal with it. Only in the cases of Mexico and Brazil is the magnitude of United States bank exposure sufficient to pose a potential threat to confidence in a total loss,

and it goes on to say that

> We recently said that we knew the recession was over because Congress was enacting a jobs bill and now it appears to us the international debt crisis is over because Congress is putting through a whopping increase in IMF quota.

I'd like to know if you agree with the Wall Street Journal that the IMF crisis is over and that we should simply fold our tent and do nothing about it.

Mr. VOLCKER. I didn't see an editorial today, but——

The CHAIRMAN. I'm sorry, not today.

Mr. VOLCKER. They had an editorial some days ago which I did see, and I do not agree with the conclusions of the editorial and much of the analysis of the editorial. I don't think the problem is over at all, and I think that is evident in developments almost week by week. A number of countries are still finding themselves in difficulty; in an increasing number of countries we still have this situation in which attitudes in the banking world have changed almost 180 degrees from what they were 1 year ago in terms of willingness to make foreign loans; we still have that fundamental problem of a rush to the door, so to speak, in terms of withdrawing from international lending that could precipitate the very crisis we would like to avoid.

I continue to believe that that situation is manageable and is being managed along the lines that have been described to you before. But it's going to take continuing effort, and it's going to take a continuing very strong presence of the IMF, and the IMF may well need additional resources to play its part in managing this situation this year, and next, and perhaps in the following year. Nobody can project just how much may be necessary, but it seems to me vitally important to have that increase in resources as an insurance policy.

It is true—to pick up another point that you mentioned—that the IMF theoretically and potentially has other means of obtaining resources in an emergency situation, but I think it is questionable whether we want to put the IMF on a course where it necessarily has to use let's say, the gold that it has, which in a sense is its capital and is part of the backing for its operations, as part of ordinary resources, which is what we're talking about.

I would not encourage the thought that that is either desirable or, frankly, very practical in the short run. A great deal of controversy has surrounded the use of IMF gold in the past. There is some precedent for that in terms of IMF expansion of resources. Among other things, when gold was used before, the very strong argument was made that, in effect, this gold was contributed by the member countries in the first place and it ought to be given back to the contributors if it is surplus in a sence to the IMF's needs. Of course, giving it back to the contributors does not direct those resources to the points of need at present, so I don't really think that that is a practical or desirable alternative to the expansion in the fund resources that is necessary.

The CHAIRMAN. You feel that Congress should act as expeditiously as possible?

Mr. VOLCKER. I certainly do. I think it is extremely important. Look at the converse, that is, failure of the Congress to act in this area where we are simply a part—an important part, a key part—but still only a part of an international effort. That would send a very strong signal to the rest of the world that necessary leadership in the United States is absent, and I think that would, for psychological as well as practical reasons, make this whole situation immensely more difficult to manage.

The CHAIRMAN. Anything I've seen in the last 2 or 3 weeks has certainly not changed my mind that no matter how unpleasant it may be to have to face the political realities of increasing the IMF quota for the United States, it is something that we must proceed with. Therefore, I'm in 50 percent agreement with the Wall Street Journal. The 50 percent comes that I agree with their comment about the jobs bill but not about the IMF.

RELAX FEDERAL INTERSTATE BANKING RESTRICTIONS

Mr. Chairman, with regard to relaxing Federal interstate banking restrictions what governmental or public interest do you feel is served by removing branching authority from individual States in determining such policies at ths Federal level?

Mr. VOLCKER. In a sense, technology may have caught up with us here. As you well know, Mr. Chairman, there is interstate banking for virtually the whole range of what might be called wholesale banking activities, international banking activities. Banking organizations in the wider sense—including holding companies, including the finance company affiliates, including the mortgage company affiliates—have literally thousands of offices these days across State lines. They have got loan production offices, finance company offices, mortgage company offices. With the speed and facility of communication these days, customers can deal with a bank at a good distance from their own locations. What is not permitted is good old brick and mortar retail banking across State lines, but it seems to me you have an increasingly distorted picture when that aspect of banking is in a rather inflexible form and so many other forms of banking go on over State lines.

We have had practical problems finding an adequate number of potential buyers, so to speak, for failing institutions these were, to a considerable extent, dealt with in the Garn-St Germain bill last year, and that has been of great help. But I think that we have reached the point where the traditional desire prevailing throughout our history—that is, to leave this question of banking structure in the hands of the States—has essentially been overtaken by events, and the present situation does lead to competitive and practical distortions.

I don't think that means you've got to jump from the present situation to complete elimination of all restrictions. There are a lot of ways that one could approach this question. I just think they need——

The CHAIRMAN. What would you prefer? Metropolitan, regional, contiguous State basis?

Mr. VOLCKER. You can combine some of these. One anomaly is that in some metropolitan areas on State boundaries you have a rather peculiar situation. A number of States recently have moved to provide for reciprocal privileges between States or within a region, as in some of the initiatives in New England. One could think of reciprocal privileges, in effect, among major metropolitan areas. One could think of entry, in a limited scale, de novo, or of acquiring smaller institutions rather than larger institutions. I don't myself have any settled view on these alternatives. Certainly, the Federal Reserve Board has not considered the alternatives, in terms of specific recommendations, but I do have a sense that there are a variety of approaches that the committee could usefully consider.

The CHAIRMAN. What do you think the Federal response should be if New England goes ahead with their six State experiment?

Mr. VOLCKER. I have some problems with the idea of a regional compact, so to speak, as a permanent feature or kind of a Balkanization in a somewhat larger context than a individual State, but as a transitional device, I don't think I would be opposed to it.

The CHAIRMAN. In other words, if States go ahead and want to make those individual compacts you have no objection to them but you feel it shouldn't be permanent?

Mr. VOLCKER. I have some reservations in thinking of that as a permanent solution. You have particular competitive interests, of course, within particular regions. I take it the Massachusetts banks are quite anxious to have a compact for New England, where Massachusetts has the biggest banks, but they're a little less eager to have banks from other States come into New England States; on the other hand, as near as I can assess it, some of the other New England States would rather open up more widely. They raise the question as to why, if they're going to allow in out-of-State banks, should they just be Massachusetts banks and not also New York or

Pennsylvania or California banks. I think there are some questions even within New England on that score.

The **Chairman**. Whatever they do, your feeling is it should be temporary and the Congress ought to act and make a policy determination?

Mr. **Volcker**. I do, indeed.

The **Chairman**. Thank you. Senator Proxmire.

WHAT PROTECTION AGAINST FINANCIAL COLLAPSE

Senator **Proxmire**. Chairman Volcker, this past week on Thursday and Friday there were two spectacular television shows on ABC and NBC, both saying that the banking system was in serious difficulty and with considerable documentation. ABC called their program "On Borrowed Time," the implication being that there's not much time to wait. NBC called theirs "Banking on the Brink," and the themes generally were the go-go banking and the rapid deregulation and the tremendously strong growth of banking that has occurred, it was suggested that maybe we're losing control of the banking system and the regulators aren't doing the job they should do.

I'd like to ask you what merit there is in this kind of a warning. After all, it was on these two major networks. Millions of Americans saw it and must be concerned about it. What protection against the financial collapse can you as our central banker and key bank regulator provide if the worldwide recession continues and we suffer a collapse of these big international borrowers?

Mr. **Volcker**. First of all, I did not see those television programs, but from what you report it seems to me that it is a sensationalization and exaggeration of the situation. I think we have a very strong apparatus in this country—and to a considerable extent there are parallel provisions in other countries—for providing a safety net under the banking system that is strong enough to prevent the kind of contagious problems I referred t[illegible] my statement.

I think it would be wrong to exaggerate th[illegible]f problems we have in the banking system today, altho[illegible] th[illegible]viously are areas of strain and difficulty. The latter a[illegible]arent, but I also think that they are plainly managea[illegible]

You asked a further question which——

Senator **Proxmire**. Well, my question is, wh[illegible]tection against the financial collapse could you provide?

Mr. **Volcker**. The obvious protection is the presence of the Federal Reserve and the powers that we have to provide liquidity in emergency situations if necessary, either to individual institutions. More broadly there are the basic protections provided by the FDIC, which have indeed been strengthened in the past year in particular by the greater degree of flexibility they have in providing capital to banking institutions that might need it for their survival or for the continuity of banking services in particular areas.

Senator **Proxmire**. You see, the problem that was raised was that some of these banks are relatively thinly capitalized, although the capitalization has improved in recent years somewhat. The argument was made that for several of the banks, loans to two or three of these countries constitute more than their capital and that banks could be technically bankrupt.

Mr. Volcker. They would be bankrupt if the loans were no good, but I'm not ready to say those loans are no good.

Senator Proxmire. I'm not ready to say that either, but if the recession continues, which is possible——

Mr. Volcker. That's right. You mentioned the recession, which is the point I had forgotten. In the international context particularly, obviously in the domestic context as well, one assumes that business recovery has started. That's not an assumption; that's a fact. The likelihood is that will continue and that is indeed an important factor in analyzing the stability and health——

Senator Proxmire. It essentially may not be the case and I'm talking about the international situation where the recovery isn't quite as evident.

Mr. Volcker. There is not certainty in that respect. In terms of the international situation, I do believe that a number of major, developed countries are in a somewhat similar phase to our own. In other words, there are signs of a more general recovery than just in the United States. But I think the analysis is that, as the recovery proceeds in reasonable order, some of those concerns that were apparently expressed on the television programs are going to cure themselves to the extent that they exist. You will find that these countries can service their loans, that their debt service burdens are declining, not increasing, and declining quite appreciably. You could make similar comments, I think, about the strains in the domestic credit fabric; in retrospect, the problems will have vanished, so to speak.

If you don't have the recovery—and obviously one always has to consider that contingency—you have a less happy situation in that sense, but you have the whole framework of protections still in place in the commercial banking world, essentially untouched. They have been used in selected instances, but they have not really been tested. It seems to me that apparatus is fully capable of meeting any tests that would be placed upon it, whatever assumptions you make about the business outlook.

REPORTING TARGETS

Senator Proxmire. Chairman Volcker, as you know, the House Budget Resolution contains a directive for the Fed requiring that you report its targets for the economy real GNP growth, nominal GNP growth, unemployment and so forth. Members of the Senate Budget Committee have been contemplating a similar amendment perhaps to the floor.

What would be the effect on monetary policy if these amendments are adopted?

Mr. Volcker. It would depend upon which one you're talking about; I'd have to look at the specifics.

Senator Proxmire. Targets for, say, real GNP growth.

Mr. Volcker. I had some concern, which I have expressed to the House Banking Committee, about the language of the resolution adopted by the House. First of all, there's a threshold question, I suppose, as to whether it really is a desirable procedure to include what may be construed as directives to the Federal Reserve in a budget resolution rather than through the normal process of the Banking Committees and full debate through that kind of channel. The implications of that approach have concerned me. That resolution, in particular, speaks to Federal Reserve objectives, in numerical terms, for a number of economic variables over a considerable period of time. There is an implication that we have objectives that can be expressed in those kinds of numerical terms, not for a single variable but for a variety of variables. There's an implication that we in the Federal Reserve can control that outcome independent of other policy measures, independent of fiscal policy, independent of other aspects of public policy and private policy. I think that's an illusion, and I think it's unfortunate to incorporate this in a resolution which which feeds the feeling that the Federal Reserve has that kind of control over the economy.

Senator **Proxmire**. But let me ask you what would happen if the Federal Reserve tried to do this? Supposing you tried to target nominal GNP growth and so on?

Mr. **Volcker**. First of all, we would find that we could not do it successfully in a short period of time, and we certainly would run into conflicts between some of the particular elements in those so-called objectives that were set forth, given that we only have one tool of policy. You're left with all the questions you begin with about trying to judge the impact of our actions in the long run as well as in the short run; that is always central to a policy issue, and putting forth objectives in those forms doesn't help resolve the issue. I think, in the end it leads to more confusion, because of the degree of specificity that they imply that really does not exist in this world. That raises a question in my mind as to what the real intent is and what the next step would be.

Senator **Proxmire**. Supposing you were asked to target the interest rates and inflation.

Mr. **Volcker**. That is a different form that some of these resolutions have taken. Again, I ask the question, is it simply a matter of economic analysis that motivates this kind of a resolution?

Senator **Proxmire**. What motivates it is the feeling that interest rates have been too high, real interest rates particularly, and that you're the agency that can do something about it and we want to know what you're going to do.

Mr. **Volcker**. That would be my feeling too, that there's something more behind it than a particular feeling of what the right technique is for the Federal Reserve to follow. It leads to the presumption that the Federal Reserve can manipulate interest rates lower, which I don't think is possible to sustain in all circumstances; it depends upon what's going on in the rest of the economy and what's going on quite directly with respect to fiscal policy. Again, the idea that we can manipulate interest rates and presumably manipulate them lower—if one reads behind to what may motivate some of these resolutions—is going to lead to expectations and pressures that won't be conducive to desirable policy.

Senator **Proxmire**. Thank you. My time is up, Mr. Chairman.

The **Chairman**. Let me just make one comment on this subject and not on the specifics or on the substance of it, but both former Chairman Proxmire, the distinguished ranking minority member of the Senate Banking Committee, and I are in accord; that whatever the substance of this debate is, that it is no business of the Senate Budget Committee and nowhwere do we find in the creation of either the House or the Senate Budget Committee in their directives to perform whatever tasks they were that theirs is the business of monetary policy. Senator Proxmire and I put in an alternative resolution to be referred to the Senate Banking Committee a couple of weeks ago and whatever kind of direction, if you want to look at the charter of the Banking Committee or the Humphrey-Hawkins legislation, it should be clear to everyone that the jurisdiction on monetary policy is in this committee and the House Banking Committee and not in either of the Budget Committees.

We both very strongly feel that way and I would hope that a majority of the members of this committee, even those who serve on the Budget Committee as well, would feel that the jurisdiction lies here and the Budget Committee should do what they're supposed to do, which is set budget totals.

Senator Heinz.

Senator HEINZ. Mr. Chairman, thank you.

INTEREST RATES ABORT ECONOMIC RECOVERY

Chairman Volcker, as we look 1 or 2 years ahead and look at the economy, would you agree that there would appear to be two alternatives, each of which have different but serious consequences, given the expected size of budget deficits. The first alternative is that there is economic recovery, that it is sustained, but interest rates go up and tend to abort that economic recovery. The other is that there really isn't any economic recovery because we can never generate the capital spending, the capital investment to fuel one, and we limp along at a very low rate of economic recovery.

It seems to me that if those are the two alternatives, given the very high budget deficits we face, and clearly getting the budget deficits down would eliminate the risk of having to face either of those two Hobson's choices, that the national and international consequences of both alternatives are severe?

Mr. VOLCKER. Yes.

Senator HEINZ. Without an economic recovery, the LDC's will never be able to expand their exports and that which you fear, namely shakey borrowers and shakey banks, is likely to become more of a reality than we would want it to. In the event of high interest rates, domestic financial institutions, the thrifts, smaller banks, would again be faced with some of the problems we like to think that they're working themselves out from under today. Would you agree with that analysis?

Mr. VOLCKER. In general terms, I would, Senator. I think you're faced with unsatisfactory choices, unsatisfactory situations with that kind of budgetary deficit, even if one takes an optimistic view of developments. At the very least, you're going to have much higher interest rates than you otherwise would have, a weak investment sector, a weak housing sector. You may get consumption pushing the economy along for a while, maybe for quite a while, but it's not a very satisfactory economic picture.

One aspect of that is important internationally and I think deserves some attention. I think the implication of budgetary deficits of the size now projected, assuming no congressional action, is that the United States, the richest economy in the world, the largest economy in the world, is going to be creating some pressures to draw savings from other countries. That works out through a depressed trading balance, a current account deficit and exchange rate that is not desirable in terms of our basic interests.

Senator HEINZ. Absent a real attack on the budget deficit, as you mentioned, by Congress and the ball is in our court, what it seems to me the implication is for financial institutions is that under either scenario there are severe strains on our financial institutions. In the first instance, internationally imposed; and in the second, domestically obvious.

Mr. VOLCKER. Sure.

Senator HEINZ. Does that mean that we would be unwise to permit—we, as Members of Congress—would be unwise to permit the de facto deregulation of banking that is currently going on as described in your statement?

Mr. VOLCKER. There's been a great deal of deregulation as you know, and I think a lot of that——

Senator HEINZ. I'm talking about the de facto and not the de jure.

Mr. VOLCKER. I just wanted to make sure of the distinction you're making.

Senator HEINZ. Well, what I'm really talking about is the pace of tremendous innovation in domestic banking and the extent to which that innovation, much of it technological, is breaking down the traditional barriers between thrifts and banks, between banks and nonbanks, between commerce and banking.

Mr. VOLCKER. I don't think I can give you a yes or no answer. That is going on. I think what's urgent is that the Congress look at it and channel it in the direction that you want it to go. An important part of that consideration is giving weight to the safety and soundness factor, which is the concern of your question. That is an important element, in my judgment, in shaping this evolution. There's going to be an evolution; technology is forcing it; the market is forcing it. But I think we also have an opportunity to channel that most constructively, and that's what I think this discussion is all about.

Senator HEINZ. Chairman Volcker, I would agree. I guess the thrust of my question is that there are broader and narrower channels that we can elect. There are deeper, therefore swifter, or shallower and slower channels we can elect, and the question is, given the kind of financial pressures that our system is likely to be under absent some very miraculous action by the Congress to the contrary, whether it is not better to keep our channels narrower as opposed to wider, a little slower as opposed to deeper?

Mr. VOLCKER. I'm not sure that narrower or wider channels are apt analogies. I think some of whats taking place is being forced through narrow channels, through the loopholes that exist so maybe you want to have a wider channel if that is, in fact, desirable.

To get to your question specifically, in one aspect at least, what can a bank or a bank holding company organization do? I would not jump suddenly into an enormous expansion of those activities. At the extreme, some people say you can do almost anything, as long as you make an attempt to insulate the activity from the bank within the holding company. I don't think insulation can be that complete, so I would be more cautious. That maybe meets your slower criteria.

In an historical sense, I think the kind of thing that we are thinking about would be quite rapid, although certainly slower than opening up the situation entirely. I think there is a question of risk involved in speed and type of activities that are undertaken.

Senator HEINZ. Now I understand that you recently wrote to the Delaware Insurance Commission in opposition to the state enacting legislation expanding banking powers into insurance securities and the like.

EXPAND COMPTROLLER MORATORIUM?

Mr. VOLCKER. The point I made, if I may just interject, was precisely the point made in my statement; that I thought the kind of legislation they were considering raised very large issues of essentially national policy.

Senator HEINZ. Yes; this I understand. Given that opposition to that kind of state banking, would that argue for expanding the Comptroller's moratorium?

Mr. VOLCKER. I certainly agree with the Comptroller's moratorium, yes. His moratorium, as I understand it, is on the de novo opening, of a nonbank bank. That is one important issue; but there are other problems that arise in terms of change of ownership of existing institutions. There are problems that arise in the thrift area that, obviously, the Comptroller cannot touch, and there are legal questions about administrative action. Yes, I would broaden it.

Senator HEINZ. Would you broaden it to include efforts to halt the unwise expansion of banking powers through state legislation specifically?

Mr. VOLCKER. Yes, I think at the extreme, I would. We faced that problem, frankly, within the Federal Reserve. We have had a policy of permitting a bank holding company to acquire a state bank and to exercise any powers that the State bank is entitled to exercise. That has been our policy. In stating it 10 or more years ago we said, of course, that we would have to review it if circumstances changed sufficiently. We faced the question whether powers in a state institution that seemed to be widely at variance with federal policies as expressed in the Bank Holding Company Act should be subject to administrative restraint, and that raises some legal questions. I think perhaps it would be better if Congress were to deal with that problem right now.

Senator HEINZ. To get to the numb of that important question, theoretically, there are two ways you can get at this. One is by modifying Regulation Y and the other is legislatively; is that correct?

Mr. VOLCKER. There are those two courses.

Senator **Heinz**. Why do you favor, if I understand you correctly, legislation?

Mr. **Volcker**. I think legislation would be the clearer way of doing it. It would be a clearer enunciation of congressional policy. I don't think you can, in the short run, as a practical matter, set down what you consider the desirable public policy over time. I would conceive of any action you took in the short run being, as you put it, in the form of a kind of temporary moratorium to give you time to sit down and decide what Federal policy should be in this area.

Senator **Heinz**. So in this instance you, if I understand you correctly, would favor a temporary moratorium enacted by Congress?

Mr. **Volcker**. Yes.

Senator **Heinz**. Chairman Volcker, thank you. My time has expired.

The **Chairman**. Senator Dixon.

INTERSTATE BRANCH BANKING

Senator **Dixon**. Mr. Chairman, I've been interested in your discussion about interstate banking. You know, the question of branching has been raised in some of the States for a long period of time. When I was a freshman in the Illinois House in 1951 we had no branching at all and that debate now has raged for three decades, although our State now has very limited branch banking.

Mr. **Volcker**. Yes.

Senator **Dixon**. It is an internal discussion that has gone on historically for so long that it's beyond the memory I'm sure of the Chairman as well as myself.

Mr. **Volcker**. That is correct.

Senator **Dixon**. I wonder how you justify your position that this committee or the Congress ought to legislate interstate banking and in effect to some extent impress upon the respective States institutional obligations they would not adopt under their own legislative system. Could I have your comment on that?

Mr. **Volcker**. I think, basically, it's a function of time and technology, Senator. Restrictions that were practicable and perhaps desirable in a day when communications were much slower, when the economy as a whole was not as integrated as it is today, when you didn't have banking done largely through computers, simply may not fit today's circumstances. As I said earlier, the practical fact of the matter is that for most forms of banking there is interstate banking now. It is a distortion in a way that was not true even 20 years ago—certainly not over 50 years ago when the McFadden Act was passed—to have certain types of banking forced into a particular mold that isn't forced on most other types of banking.

Senator **Dixon**. Let's take the reverse of that if I could for a moment, Mr. Chairman. In the case of branching, I have the idea that your perception of it would be that my State is behind, in the sense of not accommodating the branching views that I'm sure that you feel would be conducive to a more modern system. An example of reverse of that would be in the Garn bill, which I supported and which we spent a great deal of time on in this committee, one of the titles originally was a federal preemption of the usury laws in the respective States.

Now in that situation, my own State is a very advanced State. We have repealed all of our usury laws and left to the financial marketplace the adoption of the effective rate, so that you would say Illinois in that sense is a modern State so far as interest rates are concerned. But here we have the committee—and I understand that we will again revisit that question this year, though it was part of the tradeoff and we dropped it last year in the passage of the Garn bill—saying that we ought to have a Federal preemption to tell the States that they do at least for a limited period of 3 years on interest rates.

What I'm getting to is that it seems to me that in this committee which has the perception at least in the public of being a conservative committee, we continue to invade the rights of the respective States to determine their policy. I wonder, as a man who I profoundly respect and a man whose reputation would be that of a fiscal conservative, how do you view that?

Mr. VOLCKER. I view it, frankly, from the standpoint of leaving as much to the States as possible, but——

Senator DIXON. But you leave very little to them when you don't leave the banking system and the interest rates to them.

Mr. VOLCKER. I don't think it's entirely a black and white situation. I start from that premise. I reach a practical point where I wonder to what degree it's desirable or possible in this area. I am not saying you have to jump or should jump to some conception of mine or of the committee as to what the desirable approaches to branching are throughout the country. I think there are more limited approaches than that, particularly during some transitional period and maybe during some permanent period. If Illinois wants to have a single entity banking office—it's been liberalized a bit I know—I'm not sure that necessarily has to be abandoned by Federal fiat.

Senator DIXON. Let me pursue that just a little further with you. I don't mean to interrrupt. I appreciate your point of view. For instance, in the Garn bill last year, as I said, there were a great many tradeoffs. I think the Chair did a magnificent job in ultimately bringing about the passage of the legislation, given all the tremendous divergent points of view and I'm sure, Mr. Chairman, you agree with that.

INSURANCE UNDERWRITING

One of the things that we did was to take away the right of the bank to sell and underwrite insurance. Well, recently Citibank purchased a State bank in South Dakota. South Dakota, as a State, has passed a law that gives a State bank an unrestricted right basically to sell and underwrite insurance. The result of it is that Citibank is not bound by that restriction of insurance activities of national banks under the Garn bill and so forth.

While I recognize that might be proper under the law, again, I wonder about the spirit of it. Aren't we getting into a kind of confusing condition here where the contrast between State and Federal laws on a lot of these subjects leave us in a generally confused State?

Mr. VOLCKER. Yes; that is the thrust of what I'm saying. I think in some areas—and this is what you have to decide—you may want to—and I would say should want to—declare an overriding Federal interest. If you really don't think that banks, let's say, should be in insurance underwriting, or you don't think they should be in insurance underwriting on a big scale—whatever judgment you make—I think it would be anomalous to let an individual State say, "Well, I'm going to permit my banks to do that, and I'm not going to permit them just in the State of South Dakota; I'm going to permit them to engage in whatever scale they want all over the country" I would find that peculiar and unsatisfactory, if that were not congressional policy. Of course, in South Dakota you almost have a perversity in the South Dakota authorities saying, "We don't want you to conduct this business too much in South Dakota; we kind of encourage you to conduct it in other States." I think that points up the issue in its sharpest form.

Senator DIXON. I guess my final question would be, isn't this true, that all of these new financial supermarkets which are causing concern for the small financial institutions are resulting in a condition where these fears by the smaller institutions have some validity? Is it not a fact that small financial institutions do have some reasonable feelings of concern concerning these growing financial supermarkets in the country?

Mr. VOLCKER. Concern in what respect?

Senator DIXON. About their future, the smaller institutions.

Mr. VOLCKER. Some of them have that concern. I don't think the concern to my mind is an important one regarding the failure of those institutions, if I can put it bluntly. They will have a market for their franchise if they want to sell it. But and I expect that these small financial ——

Senator DIXON. Well, you hit it on the nail when you said "if you want to sell it," Mr. Chairman, in the center of your remarks just then. Isn't there some fear and some validity in that fear among these smaller institutions that the direction in which we're traveling ultimately leads us to a place where this is a country of financial supermarkets and the small institutions won't prosper?

Mr. VOLCKER. Let me get to the point of whether they can, in fact, survive or whether very large numbers of them can survive. I certainly hope so, because I think these smaller institutions have a very real role to play in the economy in dealing with local people on a local level. I think that's been a great strength of our financial system. I think we have some evidence of that; we don't just have to theorize about it. We have some evidence that we can get a mix of the supermarket, as you express it, with the boutique. In the State of California, for instance—which is a State that's had, I think, the largest branching institutions, statewide branching for many years, aggressive statewide institutions—they have also managed to preserve a goodly number of much smaller banks and thrift associations alongside those big institutions, and I think there are some interesting lessons to be learned there. I certainly would not like to see the United States end up, even in modified form, the way some foreign countries have, with just a handful of very large banks absolutely dominating the whole financial system, and with very few small and local institutions. I don't think that's going to happen, but let me say that one of the things you would want to do is encourage change in a way that maximized chances of maintaining this kind of diversity.

Senator DIXON. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Hecht.

Senator HECHT. Thank you, Mr. Chairman. Many of my questions have been answered. However, pursuing this, on your written statement on page 18, "Other activities that have been discussed raised considerably greater questions in my mind because of factors of risk or conflicts of interest that could not be contained without the most elaborate and self-defeating kinds of regulation. Corporate securities underwriting, real estate development, and, more generally, significant equity positions in unrelated nonfinancial activities fall into that category."

Now to really be specific, does that mean that you oppose holding companies engaging in selling insurance, title companies underwriting or engaging in real estate developments such as thrifts have now? Are you actually against that for the moment or down the line? Let me pin you down.

Mr. VOLCKER. I have very great questions in my mind, as the statement says. I suppose that implies that I would not be recommending it to you right now.

Senator HECHT. Thank you. One other question. Just as you alluded to in the last question of Senator Dixon, you don't want to see an America have just a few major banks like European countries. Don't you feel from this computerization and the shotgun marriages in banking today that we're on the path toward that?

Mr. VOLCKER. No; I think we are going to see more consolidation. We are seeing it even within the framework of existing law. I suppose the thrust of some of the comments that I made would facilitate some of these across State lines to some degree. But, we have 14,000 banks in this country; we have almost 4,000 thrifts; we have 20,000 credit unions; we've got a lot of finance companies; and so forth. I think we're a long way from the kind of situation you have in Canada, the United Kingdom, and some other foreign countries. Even countries like Germany and Switzerland, which have relatively a handful of dominant banks, have a lot of local financial institutions. What I'm saying is that I don't think this is a black and white question. We are a long, long way from that vision; I don't think we should get there and I don't think we will get there, but that is a consideration that you should have in mind in shaping your legislative approach.

Senator HECHT. Last week Secretary Regan was sitting there and a question was asked to him about a financial institution engaging in these different activities and he said in essence they're doing that right now. So his position is somewhat different from yours. Did you discuss this with him?

Mr. VOLCKER. I've had some general discussions with him from time to time. I don't know, in practice, how different our positions would be. I sense that his starting point is somewhat different. He seems to be taking a position that you can insulate various parts of the holding company more fully than I think you can.

It seems to me pretty clear if one part of a holding company gets in trouble, another part gets in trouble. There are obviously very strong pressures within an organization that tend to make that true. The public perception, itself, is that a holding company is a single unit.

I think we certainly have some practical differences of emphasis in that respect, but I'm not sure how different our position would be in the end. We have made approaches from somewhat different directions, we'll see how much our positions converge

Senator HECHT. Some of the fears you mentioned I brought out last week too. The human element, for instance, where a bank makes a loan on a mortgage on a piece of property always requires insurance. It is so easy for the bank to imply well we have our own people selling insurance, we have a title company we use. Do you fear the human element in this too?

Mr. VOLCKER. Yes; and I think that, quite specifically, is one of the areas the committee will want to consider when you get to the specifics, where the balance of the advantages and disadvantages lies. That is not an area, for instance, that I would exclude, offhand, from bank holding company supervision.

Senator HECHT. Thank you very much. No further questions.

The CHAIRMAN. Senator Lautenberg.

ELIMINATES OPPORTUNITY FOR SMALL BORROWER

Senator LAUTENBERG. The process of deregulation is moving, sometimes without direction, because of technology. We do see honest to goodness banking going on at the retail level in many instances with the automated equipment. We don't need brick and mortar. Your concern—and it's a concern of mine, let me say—is that as we continue the deregulation process, we eliminate the opportunity for small borrowers, the entrepreneur, individual enterprise, to have access to credit markets. I think that what we will see is more of the same which got us into trouble these past years: A search for the highest returns on funds that a bank can get, leading to competition with all kinds of other institutions.

Would you—in addition to the temporary moratorium on nonbanking types getting into the field—envision a restriction in product lines for banks whether it's insurance or money market instruments or things of that nature?

Mr. VOLCKER. Restrictions on product line for banks, I think, are basically in place. One of the things, of course, that you want to be considering is precisely where that line should be drawn.

Senator LAUTENBERG. What's an example of the restrictions?

Mr. VOLCKER. Let me immediately take that back with respect to this new state legislation. That is the issue involved, I think, in this proliferating state legislation, where very sweeping changes are being made in bank product lines without the consideration of this committee and the Congress. Really in some sense your decisions are being preempted. It is a very real consideration, and I mentioned to Senator Heinz that you may want to legislate on the point. We have to consider it from an administrative standpoint.

The other issue is nonbanks, and particularly, I suppose, investment houses, coming in at least to some aspect——

Senator LAUTENBERG. Or insurance companies.

Mr. VOLCKER [continuing]. Or insurance companies coming into some aspects of the banking business. Now they can only do it under certain restrictions, given existing law, but they can exploit openings in the existing law to get into particular parts of the banking system that are important and that they want to exploit. We in the Federal Reserve, for instance, along with a good many other people, are willing to see a combination of the money market mutual fund business, mutual funds generally, in the banking business, but that's not permitted as we read current the law.

Yet, through interpretations of some loopholes in the current law, investment houses can get into some aspects of the banking business. Those interpretations as I understand it, are not just confined to mutual funds; they would permit a more general investment banking business to take part in some parts of the banking business. If that's not stopped during this interim period, you're going to be faced with a fait accompli. Whether its's good or bad, it is another areas for your decision.

Senator LAUTENBERG. Would you recommend longer term restrictions? You know New Jersey—and I would have to tell the world that one of New Jersey's contributions to our banking society is the Chairman himself—the pot's boiling in New Jersey in terms of changing the banking industry. Waterbank, one of our largest insurance companies has a brokerage firm; now we have seen Secretary Regan's former company buying a thrift institution in New Jersey as well.

Mr. VOLCKER. I might say that in the case of your insurance company, they also own an investment house.

Senator LAUTENBERG. They also own New Jersey—not really. I used to work for that company, as I think everybody else did in New Jersey. But the fact is we are seeing this volatility. It's brewing almost in a chemical process. I'm concerned that unless we define it a bit more narrowly, the only criteria for where investments go will be greed and yield on investment. We see something very interesting in New York; the $5,000 teller line. Everybody is aware of that. Citibank has one line that has teller access only if you've got $5,000 or more in the bank. Well, that certainly doesn't speak to the service that we need in our society, especially to promote small business. I'm concerned that in the process of deregulating we will deregulate the small borrower, the small business person from contact with the normal commercial banking opportunity, and turn more and more to finance companies with higher interest costs and things of that nature.

I wonder whether you're concerned in the long run. We talked about an interim halt. What about in the long run?

Mr. VOLCKER. I think those are precisely the questions that the committee ought to be deliberating and deciding on, and these interim steps are simply to keep things in place so you can decide. I don't think they can last for long; they should not last for long. Your concerns more broadly are the same as my concerns, and I think the Chairman has taken the initiative very constructively, to force consideration of these issues. I think you must do it; it's a very difficult area, but it's become urgent for those very reasons that you describe.

Senator LAUTENBERG. I think we look more like our friends overseas, particularly in Europe—dominated by giant banks. I think the top 10 banks in the world include three French banks, including the Credit Agricole as the principal one. I think that was initially a farmer's cooperative.

Mr. VOLCKER. Of course, that's a governmentally sponsored institution.

Senator LAUTENBERG. Yes, but it's enormous.

Mr. VOLCKER. Yes, it's enormous.

IMPACT ON INTEREST RATES RESULTING FROM DEREGULATION

Senator LAUTENBERG. Do you see an immediate impact on interest rates resulting from the deregulation process?

Mr. VOLCKER. The kind of deregulation, if that's the right word, that we're talking about now, I'm not sure has any very pronounced implications for interest rates. I think the deregulation process that is well advanced—the removal of interest rate ceilings for depository institutions—has had some implications for the general level of interest rates because—And I don't say this critically—I think it means that other kinds of administrative constraints, legal constraints in markets, have been removed on the fluidity of capital. When you don't run into legal barriers, administrative barriers to changing rates, you no longer have to ration credit by nonprice terms; you ration it by price terms. In some circumstances that puts more pressure on interest rates.

In the old days—the good old days or the bad old days, whatever they were—the sixties or early seventies, when money tightened, you had these so-called "credit crunches" when thrift institutions or banks had difficulty funding themselves because they ran into interest rate ceilings which forced credit rationing. The overall level of interest rates was probably held lower than it otherwise would have been by that rationing process. That's pretty much disappeared as a characteristic of the American financial system, so that all the rationing during a restraining period comes out in terms of interest rates.

Senator LAUTENBERG. And deprives those who perhaps need it most from having it.

Mr. VOLCKER. Most economists would argue that the interest rate process is a more efficient rationing device than administrative restraints, but that's a matter that can be debated I suppose. I think the truth is someplace in between

Senator LAUTENBERG. Especially when we see the kind of investment that's made in money funds and things of that nature by the affluent—in effect, producing the capital that's producing the yield for our financial institutions so that it is not very attractive to go elsewhere.

How do you see the process affecting monetary policy generally as we continue the deregulation process?

Mr. VOLCKER. Yes, in ways that are hard to foresee, but monetary policy does work through a given institutional structure. When you change that institutional structure, you change the way monetary policy works. One aspect of that is the point I just mentioned, monetary policy works differently today than it did in the midsixties when you had all these interest rate ceilings. The fact that we now pay interest at market rates with no constraints on overnight deposits in these new money market deposit accounts blurs the distinction between a transactions account and a savings type account. That, among other things, has very direct and strong influences on the way we count money, the statistics themselves. It changes the significance of any particular monetary aggregate because you have a mixture of a transactions balance with investment or savings money. The implications for monetary policy are pretty clear, but difficult to cope with in that particular context. Whenever you change the operation of the banking system in fundamental ways, monetary policy is called upon to adapt.

I could put the point the other way. I think the operation of monetary policy is not the only consideration, but it should be one consideration in how public policy tends to direct and push the financial structure. It's one thing you should take into account.

Senator LAUTENBERG. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you. Before I turn to Senator Gorton, I must extend to him a public apology for violating my own rules of recognizing my colleagues on the basis of their arrival in the committee rather than by seniority and he was here before Senator Heinz. I simply blew it, Senator. I apologize and you are now recognized.

Senator GORTON. Thank you, Mr. Chairman.

Mr. Volcker, I found your testimony on general banking policy to be both interesting and instructive. I'd like to ask you a few questions about its impact on a particular situation of great importance to me and to the people of my State.

OWNERSHIP OF IN-STATE-BANK BY OUT-OF-STATE BANK

As I'm sure you know, the largest bank of the State of Washington, Seattle First national, has suffered such severe losses over the course of the last year as to have its capital severely impaired. Over the weekend the Bank of America has offered to purchase control of Seattle First National Bank. The State regarded the situation of the bank itself as such an alarming situation that it reversed a long-standing law prohibiting the ownership of more than 5 percent of the stock of an in-State bank by an out-of-State financial institution and the Governor has signed that bill.

Both the Federal Reserve Board and the Department of Justice now must review that acquisition. I don't, of course, want to prejudge your judgment on that. I would, however, like to ask you what factors the Federal Reserve Board will consider in its review of this shotgun merger.

Mr. VOLCKER. I think there are essentially two factors that we have to consider in any situation of this sort. One is the financial factor, the financial capabilities of the acquiring institution and the combined institution and its prospects. The other is the competitive factor. In this case, as you know, I haven't examined the terms, and it's premature, as you say, to render any judgment. Obviously the State of Washington itself seems to have provided the legal framework to make the acquisition legally possible. But, as with any application of this sort, we would have to look at those financial and competitive factors.

Senator GORTON. What practical alternatives, if any, are there either for Seattle-First National Bank or the financial structure of the State of Washington in the case of rejection of this merger proposal?

Mr. VOLCKER. I can only speak theoretically. I don't want to get into that particular situation because, obviously, in any situation of this sort, there is the possibility of proceeding, let me say, without special assistance, in the knowledge that the Federal Reserve stands there to provide liquidity support should that be necessary. There is the possibility of other acquirers either in-State or out-of-State, of recapitalization without acquisition by another institution, of supplementing the capitalization. The FDIC has certain authorities that would be relevant in some circumstances. I think all those things would apply to any bank in that kind of a situation.

Senator GORTON. So there are at least potentially other alternatives short of the bank being closed?

Mr. VOLCKER. Both good and bad, depending on the facts of the particular situation. That is, I'm sure, one of the factors that the Legislature of the State of Washington had in mind. This happens to be the biggest bank in the State of Washington and that sometimes limits options within the State.

Senator GORTON. Now speaking a little bit more theoretically, what impacts, either positive or negative, can you see arising out of the situation of the largest bank in a given State operating not independently, but as a subsidiary of a much larger bank elsewhere? I think in your testimony you implied this is something we ought to look at. Can you outline——

Mr. VOLCKER. Let me raise an issue that you might want to consider in your deliberations. Let's say you are prepared to permit interstate operations more freely than in the past. One kind of restriction that could be considered in this area—you may want to think of it either as a restriction or, in the other direction, as an incentive—is whether you want to encourage this process to take place not by combining size with size, but with size on one side and relatively restricted or even de novo entry on the other side.

That's speaking generally and not taking account of more or less emergency situations where, as in the Garn-St Germain bill, there are special rules for a failing institution. That is one of the things I would want to consider if I were looking at this situation, whether there's a way of doing this that is going to tend to enhance competition, enhance diversity in the provision of banking services, rather than contribute to concentration.

Senator GORTON. So you would have us look with some reserve or some suspicion as a general proposition at allowing this kind of merger between the largest institutions in two quite separate markets in two separate States?

Mr. VOLCKER. I think it's something you would want to look at. This particular situation has an added ingredient which I think you would have to take into account. It's not——

Senator GORTON. Totally voluntary?

Mr. **Volcker**. Exactly. There is, I think, State law that says something about an institution that is in financial difficulty. That's a different set of facts.

Senator **Gorton**. Would you apply a different rule if the financial institution which is in trouble is a bank holding company rather than the bank itself?

Mr. **Volcker**. I haven't thought that one through. I don't see why offhand, but there may be considerations that would have to be taken into account, depending upon the nature of other activities, perhaps. I haven't thought that one through apart from this size question, which may or may not be related to whether it's a holding company.

Senator **Gorton**. Thank you, Mr. Volcker.

The **Chairman**. Senator Sasser.

Senator **Sasser**. Thank you, Mr. Chairman.

Mr. Chairman Volcker, you and I have talked a number of times about my concern about the interest rates cost of money and I'm now concerned about whether the deregulation that we've imposed on the banking industry is not in and of itself greatly increasing the cost of money.

Now I've had conversations with bankers in my State asking them why real interest rates continue to be so high. In response to that question, at least one banker indicated to me that the cost of money for his bank was 9 to 9.5 percent, that by the time he pays his cost of operation, pays the interest on his deposits, that his actual cost is 9 to 9.5 percent, and that's the reason real interest rates are so high, according to this particular banker.

My question to you is, No. 1, do you agree with that; and No. 2, have we come so far with deregulation in allowing the banks to try to meet the competition of other institutions competing for money that we are defeating our overall need to move in the direction of lower interest rates?

Mr. **Volcker**. I think the kind of consideration that you mentioned, the additional cost of money to a bank coming from the deregulation process recently and rather directly, should be, to the extent it's important, only a transitory effect. The basic level of interest rates is going to be set more by the overall supply and demand of funds in the market, and returns to individual banks are going to be limited by that overall balance. During a transitional period, when banks were faced rather suddenly with these added costs, it may have been a factor making them more cautious in using the prime rate or whatever during this period; I don't think it is a factor that should in itself be important over a period of time.

I think the other aspect of deregulation, which I discussed with Senator Lautenberg, does have some continuing influences that may be as much of a cyclical nature as a continuous nature. Interest rates on the average are probably higher than they would have been under the old institutional structure, but that comes more from the absence of interest rate ceilings than from higher cost of the funds. It's a choice between rationing by interest rates or rationing by administrative means. I think that is of some significance.

I think the other factor that you mentioned is more, to the extent it's important—and I would think it's of secondary importance at best—a transitional factor.

Senator SASSER. Mr. Chairman, I want to pursue just a moment a line of questioning that Senator Gorton entered upon a moment ago. We've got a number of banks in this country that suffered substantial losses of capital and I did not realize until Senator Gorton asked the question or made the statement that the largest bank in the State of Washington was in difficulty. You're familiar with the fact that a large bank in my State became insolvent a few weeks ago, the fourth largest bank insolvency I think in American history. Fortunately, the Federal Reserve was able to merge the bank rather than declare it insolvent and simply liquidate it so this minimized the loss at least to depositors and others.

The problem I'm concerned about the overall health of the banking structure in this country at this time and I was in the State of Arkansas just over the past weekend and learned there that two banks had become insolvent in the past month.

Now I'm sure that the problem is partially caused by the long recession. The banks are partly a victim of the recession just as the unemployed have been and in some cases you could make a strong case partly a result of poor management. But you say in your statement that the struggle to meet competition—I'm now quoting you directly—"the struggle to meet competition has left depository institutions with a potentially more volatile structure of liabilities and smaller capital cushions than in the past."

Mr. Chairman, do you have any fear that we may by deregulation of the banks in an effort to make them more competitive—have we put them into in many cases an unstable situation capitalwise to the point that there is danger of a number of banks in this country becoming insolvent?

Mr. VOLCKER. I think we have a basically strong banking system. We have the apparatus, as we discussed earlier, for dealing with the problems that do exist. But the kinds of concerns that you have raised certainly should be factored into your consideration of the general structure of the banking system and the banking powers that you want in the future.

The time to worry about these kinds of problems is before you have them. It's a little late, as in the international area, to deal with these problems when they are with us. We can deal with them then, but it is better to anticipate them. I agree with the tenor of your statement to the extent that I think these are among the considerations—and certainly important considerations—that you should have in mind in developing an appropriate structure for the banking system, thrift associations and all the rest in the years ahead. But you should be concerned about the implications for the future safety and soundness of the banking system; that that has been an abiding concern of public policy and, to my mind, it remains as a concern of public policy. You will be in no better position to consider that than when you're considering these very basic structural concerns about the banking system, not just in the context of right now, but primarily in the context of 1984 and 1985. It looks to me as if you're going to be writing legislation for decades, and that's how these problems should be considered and dealt with.

Senator SASSER. Well, it appears to me, Mr. Chairman, that the banking system relies principally on the faith and confidence of the depositors and I'm concerned in that I find at least in my State a fear that for the first time since the early 1930's that perhaps there is some inherent instability in the banking structure in this country and I hear your colleague, Mr. Isaac, a man for whom I have high regard, come before this committee and other committees and he appears to be talking in terms of more deregulation. He talks in terms of marketplace forces determining, letting the marketplace determine more of the health of the financial institution and letting the marketplace define the risks for putting funds in a financial institution and to me that's unsettling to hear that at this particular time as we are trying to struggle out from under a major recession.

We're going through a period of unparalleled deregulation of the banking industry and I'm becoming concerned as to whether or not we may have deregulated too much, particularly at this particular time in our economic history.

Do you have any response that you would like to make to that?

Mr. VOLCKER. Very clearly I'm not going to speak for Mr. Isaac, but I think what we need is a blend of market disciplines. I think in the banking world we have not traditionally relied on market discipline alone and when we have we've gotten in trouble historically.

Senator SASSER. We have indeed.

Mr. VOLCKER. I think we should take advantage of those market disciplines and we should use them, but they're going to need to be supplemented and reinforced, partly because the protections we give to the banking system themselves undermine the market disciplines. I think Mr. Isaac has been concerned with the problem, quite rightly, that if the depositor has no concern about the health of the bank—because he feels that his deposit is insured—then the bank management is going to take more risks than it otherwise would take, which contributes perversely to a weakening of the banking structure rather than a strengthening. I think it's that kind of problem that Mr. Isaac has, in part, been concerned with, and I think it is a real factor that has to be taken into account in the structure of deposit insurance and in other approaches.

Senator SASSER. My time is up but I just make this comment. Realistically, it's difficult for me to see how the man on the street or the woman on the street, 85 or 90 percent of them, are going to have any real picture of what the financial integrity of a bank really is. Now the correspondent banks will know. Those that are in the know in the financial field will know. But the average man or woman that comes in that bank and makes deposits, the average small businessman, I doubt that they're ever going to really know much about the financial integrity or safety of the bank.

Maybe I'm overly concerned, Mr. Chairman. I just got through reading a book entitled "The Great Crash," about the financial crash in 1929. I came away from there with a feeling that if Paul Volcker had been Chairman of the Federal Reserve in those days we wouldn't have had that crash, I might say quite frankly. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Hawkins.

Senator HAWKINS. Thank you.

Chairman Volcker, I have a high regard for the work that the Federal Reserve Board does in consumer credit protection and I'm particularly indebted to you for sending up legislation that I'm going to introduce to strengthen the consumer leasing act. However, there's been some question raised whether the central bank should have a role so far from that of regulating the money supply.

If Congress should restructure the Federal bank regulatory agencies, would you favor the Federal Reserve retaining its consumer credit protection role?

Mr. VOLCKER. Let me put that question in this context if I can, Senator. I think it is extremely important, as I emphasized in my statement, that the Federal Reserve have a continuing, ongoing presence in certain aspects of banking regulation and supervision. Consumer credit regulation does not fall in that imperative category. That is an area of regulation that has purposes separate from the safety and soundness and general functioning of the financial system.

From the standpoint of our inherent central banking responsibilities, I don't think there is any necessary reason for us to retain that leadership, that role that Congress has given us, in consumer protections.

But that is not to say that we are unwilling in any sense to undertake that responsibility, if Congress wants to continue to lodge it with us. I don't think it's integral to our general purposes, but you have to put it someplace and I think that's your choice. You will presumably make it on the grounds of where you think the responsibility can be most effectively discharged.

CREATION OF FEDERAL CONSUMER CREDIT AGENCY

Senator HAWKINS. The report of the National Commission on Consumer Finance in 1972 found certain weaknesses in enforcement in Federal consumer credit protection laws and that Commission recommended the creation of a Federal consumer credit agency that would issue rules and supervise all examination and enforcement functions under the Consumer Credit Protection Act.

Would the concentration of the supervisory authority over the Federal Consumer Credit Protection Act in one agency be more effective in your mind than the present scheme of spreading responsibility among a number of agencies?

Mr. VOLCKER. I don't think I have enough experience in that particular area to give you a definitive answer. I have no problem with that approach from our more general responsibilities as a central bank, but I would want to consult with my colleagues and with experts in the consumer protection field as to whether that kind of proposal may have problems that I don't see immediately.

Senator HAWKINS. Why don't you study it a little bit and get back to me with me an answer on that and also whether you would recommend putting the responsibilities with the Federal Reserve Board?

Mr. VOLCKER. I would be glad to.

Senator HAWKINS. Thank you.

The CHAIRMAN. Thank you, Senator Hawkins.

Mr. Chairman, on page 19 and 20 of your testimony you discuss the need for more consistency in bank thrift regulations so thrifts should not use as a vehicle for circumventing the separating of banking from commerce contained in the Bank Holding Company Act. However, you suggest that we use the asset test contained in the Internal Revenue Code, 60 percent of assets in mortgages, which the Congress has used to designate which thrifts get the more liberal treatment than the one in the S&L Holding Company Act may not be an adequate standard.

Do you have any thoughts on what would be an appropriate standard for determining when thrifts should be governed by the same standards as banks and the banks holding companies?

Mr. VOLCKER. My feeling is that if the thrifts are really exercising banking powers there has to be consistency or all the institutions will flow to the more liberal environment. I think the difficulty with that asset test, as is illustrated by what's going on now, is that some potential acquirers—say an investment house or insurance company or others—may not be terribly interested in the asset side of the balance sheet or willing to live under asset restrictions. What they're interested in is access to the payments mechanism, the ability to issue insured deposits or to engage in other banking functions; the asset test alone doesn't get to that, but yet it provides the vehicle for them to do these essentially banking operations, completely consistent with the asset test. They achieve their purpose in doing the banking business that they want to do without the asset test interventing.

The CHAIRMAN. Do you think that's the same standard we ought to use in determining whether thrifts should be subject to the same branching or interstate operating requirements that are on banks?

Mr. VOLCKER. Again, that would be my starting point, I suppose, if they're exercising general powers. What I hint at in this statement is whether you want to facilitate what might be thought of as a two-tier thrift system. Thrifts that want to do what you think of largely as a traditional thrift business would not be subject to those restrictions, although I think those traditional thrift-like powers have to be defined a little more comprehensively than that single asset test. You might have a two-track kind of thrift industry and then, frankly, I suppose the one track that had so much overlap with banks would eventually blend into the same regulatory framework as the banking system itself. That's pretty vague, but I can see that possibility as one avenue that you might want to explore.

The CHAIRMAN. On April 6 when Secretary Regan was here he said, "The administration supports the goal of allowing all depository institutions ultimately to perform the same type of business so that they are free to choose whatever specialization they wish."

Do you agree with that concept of Secretary Regan of homogenizing the powers and regulations of all depository institutions and letting them choose what they want to do.

Mr. VOLCKER. I don't know just what context it was in, but if I interpret it literally, I am not saying that. I am not saying, as I think my statement implies, that I'm ready to see the complete range of investment banking activities or at this point a complete range of insurance activities or real estate—I don't know whether a real estate development is financial or nonfinancial; we get into those kinds of questions—completely homogenized. I think there are some limitations in terms of the powers that are appropriately associated with the legal entity known as a bank.

The CHAIRMAN. Well, he goes on to say, "The administration believes all the depository institutions should have equal powers and should be free to chose whatever specialization they wish." So it's not out of context.

Mr. VOLCKER. No; I didn't want to suggest it was out of context, but I didn't know whether he was including all kinds of underwriting and everything else in that statement.

The CHAIRMAN. Well, he is, but of course then he gets into the issue of the separate subsidiaries which the administration also very strongly supports.

Mr. VOLCKER. He wants them in separate subsidiaries, I understand. What I'm saying, specifically within the limitations of depository institutions, is that I think the situation forces consistency in treatment among banks and thrifts as to their powers. You could just leave it there: they can all do anything within that general boundary that's established. I just simply raised the possibility of whether you might not still want to carve out more limited functions for some types of institutions, more along traditional thrift lines. It would be a little different from the boundary established historically, but that would provide room for some specialization and for more privileges in other directions. It's an issue that I would put on the table for you to consider.

The CHAIRMAN. We've got a lot on the table.

Mr. VOLCKER. What impresses me again and again is how much you have on the table to consider.

The CHAIRMAN. In response to my colleague from Tennessee, he talks about have we gone too far. We didn't even scratch the surface last year of the issues that need to be addressed. We barely even began to look at the multiplicity of problems that are developing through technology and the innovations.

Mr. VOLCKER. You are exactly right and, of course, as a side effect of some of the things you did last year, particularly of this thrift-bank thing, the problem is more pointed, simply because thrifts have more powers; you're almost forced into that more comprehensive examination.

The CHAIRMAN. You expressed concern about combinations of nonbank banks or thrifts with nondepository institutions. To clarify that, are you referring only to nonsupervisory mergers?

MERGERS

Mr. VOLCKER. No, but I recognize, particularly in the thrift area, that that is a subproblem that exists. If they have a problem of finding merger candidates for some institutions, then to the extent the range of candidates is limited, that is a consideration. I think the problem is general.

The CHAIRMAN. But you would agree that mergers that fit under the terms of the section of the Garn-St Germain bill last year should still be permitted, troubled institutions following the formulas?

Mr. **Volcker**. I think there should be more liberality in terms of failing institutions. I have no trouble with the interstate provisions. I strongly advocate them, in fact, as well as the commercial bank/thrift combinations as an exception to the general rule. When you have these emergency situations, as a practical matter, some allowance has to be made there. Precisely where to draw the line is a question. You could have a large investment house, let's say, acquiring under that rule a very small thrift. You haven't achieved much in terms of supervisory purposes, but you have provided the opening for the very combination for which you want a moratorium. That is a problem that has to be worked out.

The **Chairman**. On page 22 of your testimony you suggest that it may be time to rationalize the situation of interstate banking and begin to address the sticky issues raised by the McFadden Act and the Douglas amendment and you further suggest a transition period. What do you envision as the ultimate goal of changing McFadden. We discussed this a little bit before—regional, contiguous States. Do you envision ultimately that we have full interstate banking and what type of timeframe would you envision in going through this process of whatever you consider the ultimate goal is?

Mr. **Volcker**. I don't think I have a fixed and strong view of that. There may be some half-way house, so to speak, that would be a reasonable stopping point more or less permanently. I don't know whether you would say "going all the way" would encompass the kind of situation where holding company organizations were permitted to acquire banks across State lines, but within certain restrictions—let's say as to the size of the institution or the market share of the institution that they were acquiring. That might be a satisfactory situation more or less permanently; I don't know. But I don't think you necessarily have to go all the way. I think that is something the committee would want to consider. You certainly don't have to go all the way in step No. 1. I think it's also fair to say that the longer that issue waits, the more persuasive the case becomes for very little transition in the formal, legal sense, because so much is going on anyway and your step-by-step approach is pointless at the point where the market has done 90 percent of your work before you've acted.

The **Chairman**. Senator Proxmire.

Senator **Proxmire**. Chairman Volcker, you seem to be addressing the South Dakota case pretty directly it seemed to me. Maybe I'm wrong. On page 8 you said:

> The Federal Reserve, in administering the Bank Holding Company Act, has for some years maintained a policy of permitting State-chartered bank affiliates of bank holding companies to engage in any activity such a bank is permitted to engage in under its State charter.

Then you say at the bottom of that paragraph—

> I believe that policy should be reviewed to consider whether the result is to undercut the Federal standards set forth in the Bank Holding Company Act, particularly when the wider powers might clearly be exercised largely beyond the borders of the state providing the authority.

Obviously, the review would be conducted by the Federal Reserve.

Mr. **Volcker**. I did not mean to exclude—in fact, I mean to rather include—your review as well.

Senator **Proxmire**. Well, except you know the way these things are. If you relax a little bit, let time lapse and so on, then you have the banks into this field and it's much harder to stop it.

Mr. **Volcker**. Right.

Senator **Proxmire**. In view of the fact that this seems certainly to this Senator at least to be a loophole in the Fed regulations with Citicorp acquiring this bank in South Dakota, using the bank to buy an insurance company. The insurance company probably operating very largely outside the State of South Dakota, and it seems to me it's inconsistent with the Bank Holding Company Act and congressional intent.

Why don't you move swiftly, say by 3 o'clock this afternoon to close this loophole? I don't mean to be precipitous, but I think such an action of that kind would have a salutary effect.

Mr. **Volcker**. I have to confess the Federal Reserve doesn't have a reputation for moving quite that swiftly.

Senator **Proxmire**. Well, maybe tomorrow.

Mr. **Volcker**. I think we do have to consider that. Now let me say that we——

Senator **Proxmire**. What do you mean when you say we do have to consider it. I'm serious about prompt action. Are you going to wait 6 months or 1 year or so before you act?

Mr. **Volcker**. No. In the case of the acquisition of the South Dakota bank by an out-of-State bank, somebody cited that as a fait accompli. We have to provide the permission for that. It's a holding company acquisition. One of the problems, frankly, with the Federal Reserve acting—and among the other questions that we would have to resolve—is that if a South Dakota bank did that—not as part of a holding company, and without involving any interstate or in-State acquisition—we would have no control over that.

Senator **Proxmire**. That's a hypothetical situation. This is an actual situation. You do have control.

Mr. **Volcker**. We're going to have to look at that actual situation and make up our mind about this actual case.

Senator **Proxmire**. Any notion whether you're going to act within the next month or so?

Mr. **Volcker**. I think we'll have to look at it in that kind of a time frame, yes.

CONSEQUENCES OF REMOVAL OF ALL RESTRICTIONS

Senator **Proxmire**. Good. In your view, what would be the consequences if all restrictions on interstate banking or holding company acquisitions were removed?

Mr. **Volcker**. All restrictions—holding company, direct branching, so forth?

Senator **Proxmire**. Unrestricted nationwide branching?

Mr. **Volcker**. Unrestricted nationwide branching. If all of a sudden you pass that law—tomorrow or 3 months from now—I think you obviously would have a lot of pushing and hauling in the banking system, a lot of scrambling around for choice franchises, choice States, choice markets. You would have very active bidding for existing institutions.

Senator **Proxmire**. So we have the problem Senator Sasser raised a little earlier and Senator Dixon, that you would have a situation where a local community would find that they had to do business with a big bank in New York or a big bank in Chicago or Los Angeles and not with a locally owned bank?

Mr. **Volcker**. I'm just speculating here, of course, without giving enough thought to your question. I think the scramble, initially, would be for larger institutions. If it's absolutely unrestricted, I think many of the larger banks would be seeking the largest stake they could get in another State. They would be leaving small banks aside for the moment. It might have, and would have some competitive implications for those smaller banks, but I don't think the scramble would be directed toward the rural banks or the country banks; it would be directed toward the larger banks with a large State presence already.

Senator **Proxmire**. But you have a very interesting phase "for the time being." In other words, that might be the first step along the way toward moving in the direction of a Canada or the United Kingdom and most of the countries in the world.

The **Chairman**. Mr. Chairman, may I just add we are not going to do that by 3 o'clock this afternoon.

Mr. **Volcker**. That's why I haven't thought through the answer completely.

Senator **Proxmire**. I didn't ask by 3 o'clock on that one. I'll give you until tomorrow.

Mr. **Volcker**. We have now the phenomenon, as you know, of some larger banks staking, or trying to stake out, a preference—that's the word that comes to mind; it's not a good legal word because we control it—an interest in an out-of-State bank, looking toward the day when the ownership interest restrictions are removed. Of course they are making a limited investment within the scope of present law. All sorts of questions have been raised, at the borderline, as to when those acquisitions of some ownership interest become control. We've had to issue very elaborate and difficult guidelines to try to distinguish between control and noncontrol. It is one area in which these pressures of today's market are very apparent, and we need some congressional guidance in that area, too. But my purpose in mentioning this is that those clearly tend to be cases where a particular bank is looking for a particularly aggressive acquisition in another State. They're interested in acquiring at least a psychological toehold on some large institutions that are strategically placed within a State. Those don't involve a lot of very small institutions. They involve some of the largest institutions.

Senator **Proxmire**. Mr. Chairman, you touch upon consolidation of the bank regulatory agencies but about all you say is that the Fed needs to play a role in regulation. Should we consolidate the three bank regulatory agencies and should we include the Home Loan Bank Board?

Mr. **Volcker**. Generally, I have felt that something short of that full consolidation is preferable. Obviously, some degree of consolidation is possible, and the ultimate answer would depend upon how it was done. That matter is under consideration by an administration task force as you well know; in this case, I participate in the task force.

The issues are very difficult. One of the problems is that it's hard for me to visualize an appropriate regulatory structure before some of these decisions are made on the substance, on the powers, on the scope, on the range, and on the differentiation left between thrifts and banks.

The regulatory structure is, in part, consequent on those decisions; that has very direct implications. I would put simple logic to my interest in retaining a role for the Federal Reserve; I think it is, in fact, very important to the central bank that it has a role in this area.

Senator PROXMIRE. You make a strong argument for limiting bank holding company activities because of the difficulty of insulating the banks from their affiliates. I have stressed for a long time what I think is an important competitive improvement in permitting banks to underwrite revenue bonds. It's just an accident that they weren't allowed under Glass-Steagall because at that time revenue bonds weren't in existence significantly. Should banks be permitted to underwrite revenue bonds? Would that increase competition in this area and tend to bring down the interest rates a little bit or at least the negotiation rate a little bit?

Mr. VOLCKER. Yes; I think that's quite a reasonable extension of bank powers.

Senator PROXMIRE. The original purpose of Glass-Steagall was to prevent conflict of interest between commercial banks and investment banks. For example, in the 1920's when the large banks made bad loans to foreign countries the banks bailed themselves out by selling bonds of those countries to an unsuspecting public. Now the banks have to go to the IMF for a bailout. Are the basic purposes of Glass-Steagall still valid today?

Mr. VOLCKER. Certainly some of them are, yes. That's why I expressed some hesitancy about a full integration of commercial and investment banking, even if "insulated" in holding companies.

Senator PROXMIRE. Can you give us a notion of which ones you think are valid today in terms of the Glass-Steagall?

REVENUE BONDS

Mr. VOLCKER. You just mentioned revenue bonds. That's one that doesn't bother me. I think some form of mutual funds doesn't bother me in principle, as a reasonable extension of the investment activities of banks. When you get into the other extreme, equity holdings and underwritings, I have the most question. The in-between area, I suppose, is corporate debt underwriting. There, I personally have very substantial questions about whether you want to combine that judgment and distribution of long-term securities with a bank lending function, even if they're in separate parts of the holding company. The good old-fashioned core of investment banking services, underwriting for private companies, I feel cautious about.

Senator PROXMIRE. Thank you, Mr. Chairman.

The CHAIRMAN. Before I turn to Senator Riegle I might announce that at 9 a.m. on Thursday we will have here in the Banking Committee the markup on the IMF quota increase and also the Ex-imbank reauthorization. Senator Riegle.

Senator RIEGLE. Thank you, Mr. Chairman.

When you mentioned revenue bonds, were you thinking of banks handling them directly or through a separate affiliate?

Mr. VOLCKER. Frankly, we have taken a position historically, that they didn't need a separate affiliate if they did the underwriting in general obligations in this particular area within the bank; I don't think serious problems have arisen. I don't think we feel strongly about that particular service being in a separate affiliate. The Treasury has made the point very strongly that for regulatory purposes—consistency of regulation, in part—there is convenience in having it in a separate affiliate. I think there is something to that argument. I'm left with a practical question as to whether you want to force all the existing banks that conduct that kind of operation within the bank to have to reorganize. That's a practical question. I think there is, conceptually, something to the Treasury view myself.

Senator RIEGLE. Yesterday the newspapers reported widely, as you know, that Merrill Lynch agreed to buy an S&L in New Jersey. I wonder how we distinguish Merrill Lynch from a bank, and if you think in this kind of case the regulators should perhaps be making a decision on this before the Congress actually acts in this area?

Mr. VOLCKER. I think basically, no. That's the thrust of what I say in my statement. I think it is preempting your consideration of the issue. The only problem that arises in that area with respect to thrifts, as Senator Garn raised the question, is what do you do in the case of a failing thrift that has potentially no other buyer? I don't know how——

Senator RIEGLE. That is a different story than the one here. That is not the case in this instance.

Mr. VOLCKER. I'm not familiar with the condition of the S&L that's being acquired.

Senator RIEGLE. Apparently the S&L is in good shape.

Mr. VOLCKER. If it's in good shape, I think it's a clear case of in effect preempting a public policy consideration.

Senator RIEGLE. So your bottom line would be that you would like to see the regulators hold up on this until Congress deals with the recommendation?

Mr. VOLCKER. Yes; that may take your action in passing a law.

Senator RIEGLE. I notice on page 6 of you statement in the second paragraph you say, "The new vocabulary springing up of 'nonbank banks,' 'thrift banks,' 'money market fund checks'—seemingly inconsistent on their face—reflect the blurring of traditional institutional lines and functions."

Then you go on to say, "Some of it is healthy, and some is not."

What is the part that is unhealthy that caused you to file that disclaimer?

Mr. VOLCKER. I think the part that's healthy is the general——

Senator RIEGLE. The unhealthy part.

Mr. VOLCKER. I was just setting up the contrast: what's health is more competition and service to the consumer. The part that's potentially unhealthy is whether it violates the concerns of public policy about risk limitations on banks, whether it leads to conflicts of interest, whether it leads, potentially, to undue concentration of resources—all the traditional concerns of public policy. I think there is another factor that is, in a general sense, unhealthy in the present situation; that linkages are forced into what might be called "unnatural channels," simply because that's the particular loophole that was found. If some of these things are appropriate, they ought to be appropriate more directly, rather than through finding some tortured interpretation of the Glass-Steagall Act for certain limited purposes.

POSSIBLE REAPPOINTMENT

Senator RIEGLE. I want to switch to an entirely different topic and I don't want to get into the speculation that we have been in before in this committee and in others about your possible reappointment. But I do want to say that although I do not know how that issue is likely to be resolved. It is hard for me to recall a witness that has come before this committee that has been more forthright than you, over the period of time that you have been appearing here. I have always found your testimony to be direct, candid, complete, and very helpful, and the service that you have rendered has been above and beyond the call of duty in personal terms. So I ask this question with that feeling: looking down the road 5 or 10 years, regardless of whether you are asked to stay on in the Federal Reserve, as you look at the banking system and the evolution and revolution that is underway, can you give us any insight as to what kind of a banking system we ought to be anticipating or aiming toward for 5 or 10 years out? I realize that is a long time, but I am wondering if there is any sort of overall conceptual guidance that you might be able to offer. I think you bring as much insight into this kind of question as anybody we could ask.

Mr. VOLCKER. I think I could only answer that question by referring to that philosophically, if you will, portion of my statement on pages 9, 10 and 11, where I presume certain characteristics of a banking system. I, obviously, look toward a strong, competitive banking system. I think you look toward a banking system that not only fulfills its traditional functions, but is also able to respond to technological change by engaging in some activities that we haven't traditionally associated with banks. So long as those activities can be fit into the risk criteria and avoid the problems of conflict of interest and concentration that I mentioned earlier.

I do think that we have gone, as a matter of generational change and change in human memory, from a highly conservative banking system—one that grew out of the problems of the twenties and thirties and had a very restricted conception of its own mandate—to a much more aggressive approach in recent years. Many decades have passed since there was any problem with safety and soundness guides and people feel the governmental support apparatus is so strong that they don't have to worry about safety and soundness considerations.

The constant challenge of public policy, recognizing psychology tends to swing strongly over a series of years, is to maintain a balance between innovation and risk taking and the continuing concern for a sound banking and asset and liability structure. Achieving that kind of balance is, of course, directly at the heart of the continuing interest of the Federal Reserve in the financial system, but I think it ought to be very important in your considerations, as you set the general parameters of the banking system.

INTERNATIONAL PROBLEMS

Senator RIEGLE. Along that same line, would you assess the greatest problems or risks today that are facing financial depository institutions and thrifts.

Mr. VOLCKER. I'm inclined to answer that this is only one aspect of the prudential terms that I just used. We've got these international problems. We've got domestic credit problems. I think we can work our way through that. It is very much related to the performance of the economy as a whole. Whatever that performance is we have the apparatus of a last resort mechanism for protecting the public interest in the depository situation. This also has to be put in the context of providing a balance of competitive opportunities for banks, too. There's no use in having an absolutely strong banking system but finding it becoming a tiny part of the whole financial system. You then don't have the leverage and the hold that's necessary. You always have to be concerned about a context in which banks can compete; that's a criterion you have to have in mind.

That's not one that the banks themselves are likely to let you forget. It's a balance in both directions. It's not just a question of the competitive ability of banks; rather, you've got to achieve a balance between competition and prudential concerns. I keep coming back to that balancing consideration.

Senator RIEGLE. If I could just ask one other thing Mr. Chairman. It is difficult for all of us to follow the international lending issue as closely as we might like, but last week Brazil said they would need another $3 billion. Meanwhile, the signals out of Mexico are still ambiguous. Although Mexico is making efforts to conform to agreements with the IMF, Mexico's situation still seems weak.

As you assess these nations, in the most difficulty right now, either in terms of servicing existing loans or needing more money, are you convinced we have really turned the corner on this problem and really have it in hand or are we still in a fairly delicate state here?

Mr. VOLCKER. There's no question we're still in a delicate state. This question came up earlier. I don't think we've turned a corner in any sense that implies we can relax. I don't believe that at all. I think it's evident in the problems that these countries still have. I happen to think there are very promising signs in Mexico; they face a very tough adjustment problem, but that adjustment may be proceeding just as rapidly, maybe even more rapidly than could have been anticipated a few months ago. I don't want to suggest that they are out of the woods. Other countries are in still more ambiguous positions. I don't think the problem is over at all, but I would repeat that I think it is being managed and is manageable. Nobody should be deluded into thinking that it's got the momentum for resolution that makes the International Monetary Fund legislation any less imperative, in terms of our ability to continue to manage the situation.

Senator RIEGLE. I've heard some people close to this problem say that it is conceivable that Mexico might have to come to the U.S. Government for direct help, in billions of dollars of assistance, before the year is out. This would be in addition to IMF help. Do you get any sense that that is any kind of a realistic possibility?

Mr. VOLCKER. No, not unless you put it in Mexican terms of a catastrophic further fall in the oil price.

Senator RIEGLE. A fall from $29?

Mr. VOLCKER. Yes; I guess it's around $29 now, in terms of a benchmark of Arab crude. Assuming that level or something reasonably close to it persists, I don't see any prospect that you mentioned.

Senator RIEGLE. Thank you.

The CHAIRMAN. Thank you, Senator Riegle.

Mr. Chairman, this is such a broad subject we could go on asking you questions for days. A lot of technical questions as we pursue the review of Glass-Steagall and McFadden through not only the next few weeks of hearings but undoubtedly over the next couple years. We did discuss the IMF earlier in some detail and a few minutes ago I announced we would hold the markup on the IMF quota increase on Thursday morning at 9 a.m.. At that markup we will be working from a committee print on which I have worked with Senator Proxmire and with Senator Heinz to achieve a workable balance between preventing future lending overexposure and insuring that international lending arrangements are not upset or chilled. I especially appreciate the efforts of Senator Heinz as chairman of the International Finance Subcommittee and Senator Proxmire as ranking minority member of that subcommittee of bringing us to the point where we could come up with a committee print that is generally agreed upon and move to a markup on this Thursday. Thank you very much, Mr. Chairman. We appreciate your testimony.

[Whereupon, at 11:45 a.m., the hearing was adjourned.]

FINANCIAL SERVICES INDUSTRY—OVERSIGHT

Part I

WEDNESDAY, APRIL 27, 1983

U.S. Senate,
Committee on Banking, Housing, and Urban Affairs,
Washington, D.C.

The committee met at 9:30 a.m. in room 538, Dirksen Senate Office Building, Senator Jake Garn (chairman of the committee) presiding.

Present: Senators Garn, Heinz, Gorton, Hawkins, Hecht, Riegle, Sasser, and Lautenberg.

OPENING REMARKS OF CHAIRMAN GARN

The Chairman. The Banking Committee will come to order.

This is the third day of oversight hearings on the conditions in the financial institutions industry to specifically look at Glass-Steagall, McFadden, the Douglas amendment, and the Bank Holding Company Act.

I'm happy to welcome our first panel this morning, the Honorable William M. Isaac, Chairman, Federal Deposit Insurance Corporation; and the Honorable C. Todd Conover, Comptroller of the Currency, Department of the Treasury.

Gentlemen, we're happy to have you with us this morning and, Mr. Isaac, if you would like to proceed.

STATEMENT OF WILLIAM M. ISAAC, CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

Mr. Isaac. Thank you, Mr. Chairman. We appreciate this opportunity to present our views on some of the major reforms we believe are needed if we are to maintain a responsive, stable financial system in the years ahead. We commend your foresight in conducting these far-ranging hearings. We have submitted a more complete statement, which I would like to ask to be made part of the official record.

The Chairman. It will be included in the record in full.

[Complete statement follows:]

FULL STATEMENT
BY
WILLIAM M. ISAAC, CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION

Mr. Chairman, I appreciate the opportunity to appear this morning to discuss some of the many issues which we believe should be considered if financial deregulation is to move forward in a sound and responsible manner. We commend the Committee's efforts in addressing the complex questions posed by a rapidly-changing financial environment.

I would like to direct my comments to three principal areas: (1) expanding the permissible activities and geographic coverage of banking organizations, (2) modifying the deposit insurance system to foster a greater degree of market discipline, and (3) reorganizing the federal regulatory structure as it relates to financial institutions. There are some important interrelationships among these areas, and I believe they can be placed in better perspective by reviewing some aspects of banking history.

Commercial Banking: 1930s-Present

The 1930s was a period of great turmoil for both the banking system and the economy as a whole. Congress responded to the banking crisis by enacting major legislative reforms, primarily designed to discourage bank risk-taking and to ensure the safety and soundness of the commercial banking system.

As part of the Glass-Steagall Act, banks were prohibited from participating in what were perceived to be high-risk securities activities. Deposit interest rate ceilings were imposed to restrict competition and reduce the cost of bank deposits. It was intended that lower cost deposits would encourage banks to invest in less risky assets. The Federal Deposit Insurance Corporation was established to restore confidence in the banking system by providing partial protection to depositors in failing banks.

Deposit insurance discouraged bank runs and limited the extent to which failed banks brought down other banks. As the economy advanced slowly and unevenly in the mid-to-late 1930s, the number of bank failures declined. While the FDIC undoubtedly played a significant role in reducing failures, other factors (expansionary government policies, reduced unemployment, fewer bankruptcies and a more accommodative monetary policy) enhanced banking performance.

Although the banking legislation of the 1930s involved major reforms, its immediate impact on banking behavior was probably quite limited. Bankers, in an understandable reaction to the depression, were extremely conservative; thus, the level of risk-taking remained low. Market entry was restricted by the cautious behavior of regulators and by a still-depressed economy. In addition, competition from nonbank companies was very limited.

During and immediately after World War II, government financial policies and private sector restrictions produced an expanding, very liquid banking system. Bank failures declined significantly. Loan losses were practically nonexistent. In fact, many banks experienced sizable recoveries on previously charged-off loans.

During the next couple of decades banking behavior continued, by present standards, to be very conservative. Economic performance was favorable. Recessions were generally short; business failures and loan losses were low. Until about 1960 banks continued to operate in a very insulated, safe environment. In the 1960s banks took steps to expand what they could do. Branching restraints were liberalized, deposit interest rate ceilings were raised and banks once again began to venture into securities-related activities.

From the beginning of federal deposit insurance, some expressed concern that the presence of deposit insurance might limit market discipline. However, either because of their own conservative behavior, existing legislative constraints or the behavior of bank supervisors, most banks operated during much of this period at a level of risk where market discipline probably did not matter. There was occasional discussion about variable-rate premiums, but it was conceded that 1930s' experience might not be relevant, and bank failures and loan losses were too infrequent to provide the bases for any statistical analysis.

In more recent years, however, banking behavior has changed in many respects. Earnings have been more volatile and loan losses have risen dramatically. More and more bank funding has involved purchased money, even for moderate-sized banks. Demand deposit balances have become relatively less important and, in the case of the household sector, most of these now pay interest. Because of the deregulation of interest rate ceilings, most deposits have become more expensive. Activities and geographic markets have expanded and competition from financial conglomerates has increased. While some of these events represented sudden developments, more often they reflected a gradually changing regulatory and competitive environment.

The economy's performance during the past 10 years has not been very strong. Recessions have been more severe. The one from which the economy is just emerging is by far the most severe in the post-World War II period. Some high-flying sectors in the economy (real estate development in the mid-1970s, some energy activities more recently) have encountered serious difficulties, causing major loan problems. Business bankruptcies recently surpassed any level reached prior to the 1930s. A weak international economy, overly expansive policies of governments and overly aggressive lending policies by some U.S. banks have made our banks vulnerable to the performance and policies of foreign governments.

Bank failures have increased during the past decade and even more dramatically during the past year. In 1982 alone, the FDIC handled 42 bank failures. We expect the failure rate for 1983 to be at least as high. So far this year 15 banks have failed. It is difficult to determine how much of this is due to changing bank behavior or how much can be explained by the economic environment. Clearly both have been important. In any case, there is a greater sense of bank exposure and risk of failure that exists not just among those who regulate and follow banks but with the general public as well.

Risks have increased and the nature of competition has been altered. Competition has become more intense because of the removal of deposit interest ceilings, technological innovations, relaxation of geographic limitations and entry by nonbanks into previously sheltered product lines. The resulting pressures on profit margins are providing a strong incentive to banks to expand into new lines of business and to seek both higher returns on their traditional types of investments and new sources of noninterest income.

With this perspective in mind, let me now turn to the main issues before us.

Expanded Powers for Banks

As you know, in recent years, nonbank companies have increasingly entered traditional bank markets, in many cases by purchasing their own "bank" or thrift institution. However, depository institutions are prohibited from entering most of the nonbank markets in which these firms operate.

Thus, Merrill Lynch offers a cash management account that directly competes with banks and thrifts for the deposits of the general public. American Express owns a securities firm that, in turn, owns a federally-insured bank; but depository institutions are excluded from most securities market activities. Travelers Corporation plans to offer federally-insured money market accounts and Prudential-Bache has announced its intention to purchase a commercial bank; but in most states banks and thrifts cannot underwrite insurance. National Steel and Sears own S&Ls and Gulf & Western owns a federally-insured bank; yet depository institutions are excluded from the wide variety of activities in which these firms compete.

The result of all this has been an increasingly inequitable financial marketplace. While we do not automatically assume that the solution is to dismantle all the barriers that separate depository institutions from commercial enterprises, we do recognize that it is no longer possible to completely insulate banks and thrifts from the market pressures generated by a wide array of nondepository competitors.

We believe that banking should remain separate from general commerce. Otherwise, the risks to safety and soundness would be too great, conflicts of interest could not be avoided, and the potential concentration of economic power would be unhealthy. Let me give one example of a serious potential conflict. Imagine that the nation's largest bank were acquired by the nation's largest oil company and that a competing oil company needed financing. If the loan were turned down by the largest bank, an important source of credit would be denied. If the loan were granted, the bank would gain access to, and a degree of control over, the business plans and strategies of an important competitor of its parent. Once the line of credit were established, it would be extremely difficult to terminate it even for good cause without raising charges of foul play.

In order to maintain the separation between banking and general commerce, we need to recast the definition of a "bank." It seems clear that the current definition has lost meaning. The overriding characteristic that banks possess, which warrants that they be treated in a manner somewhat different from other types of institutions, is that banks accept deposits from the general public for which the federal government has assumed the responsibility of safeguarding. This responsibility necessitates that banks be subject to some federal regulation and supervision, from which nonbanks are exempt. With this in mind, it may be appropriate to define a bank as any institution that offers any type of federally-insured deposit. This would create a clear and useful distinction between banks and other types of financial institutions. S&Ls, which for all intents and purposes are commercial banks, would be defined as such. The current "loophole," which allows nonbank companies to acquire banks simply by divesting themselves of either the bank's demand deposits or its commercial loan portfolio, would be eliminated.

Beyond changing the definition of a bank, we need to reconsider the range of activities in which a bank or its affiliates may engage. In our opinion, a bank should be permitted to engage, either directly or through a bank subsidiary or holding company, in a full range of financial services. Activities in which banks are currently permitted to engage, or additional activities in which banks act as agent or sell services, should be permitted within the bank itself. Among the activities we would be inclined to include in this area are: brokerage activities related to securities, real estate and insurance; travel agency services; and data processing services. Riskier activities, such as underwriting securities, real estate development, and underwriting property, casualty and life insurance, should be placed in separate bank or holding company subsidiaries. In addition to placing the higher risk activities into separate subsidiaries, a number of safeguards would be needed to limit intercompany dealings, require independent capitilization and funding, minimize conflicts of interest, and limit the overall exposure of the banking organization.

Expansion of bank powers will result in important benefits to the general public by providing more services at competitive prices. It is our view that these benefits outweigh concerns that banks will be exposed to higher levels of risk. This does not mean that we intend to allow bank risk-taking to go unchecked. The FDIC is currently considering a number of policy changes, which I will address shortly, that will enable both ourselves and the private sector to better control excessive risk-taking by commercial banks.

We do not believe any of these new powers need to be placed in a holding company subsidiary as opposed to a bank subsidiary. The arguments for such a separation -- that the bank will be better insulated from additional risk or potential conflicts of interest and that competition will be on a more equal basis -- are not persuasive. Past experience has shown clearly that banks cannot be insulated altogether from the risks of their affiliates. A bank subsidiary can be structured to provide just as much protection as a holding company subsidiary; indeed, it might be better if these activities were offered through a direct bank subsidiary where the bank regulatory agencies would be better able to monitor them.

Many banks and thrifts do not currently have holding companies, and we perceive no social or economic justification for encouraging their formation (indeed, thrifts organized in mutual form cannot do so). A bank subsidiary can be required to have separate funding sources and capitalization and can be regulated in the same manner as a holding company subsidiary.

A principal reason we favor expansion of bank powers is to permit banks to offer their customers a wider range of financial services. The banks will presumably use the new sources of income to help offset the pressures nonbank competitors are placing on their traditional sources. A separate holding company subsidiary would, in effect, take income from the bank by cross-selling bank customers. We would much prefer that income to be generated in a direct subsidiary of the bank where it would enhance the bank's earnings and capital.

Once it is determined what new powers are to be extended to depository institutions, it follows that any company engaged in such activities should be permitted to own or affiliate with a bank or thrift institution and that any company engaged in impermissible activities should not. Nonconforming companies already affiliated with banks or S&Ls could be given 10 years to either conform or divest. This will ensure that the boundary lines, once drawn, are fairly and consistently applied to all firms, banks and nonbanks alike.

An expansion of banking powers might increase the risk involved in banking. However, it should be noted that not all restrictions (including some developed specifically to protect depository institutions, e.g., rate ceilings, branch restrictions and asset restrictions) have necessarily reduced bank risk. Nonetheless, we should keep in mind that determining what institutions can do and where they can do it should not be determined solely (or principally) by risk considerations. More relevant are such considerations as improved services to the public and a more efficient allocation of resources. Risk can be controlled by proper insulation of the activities and through capital standards and other financial policies.

You have also asked for our views on geographic expansion by banks. In many respects we already have nationwide competition for most financial services. The wholesale banking market has long been a national one. On the retail lending side, we have national firms, some of which are bank affiliates, making consumer and real estate loans on virtually a nationwide basis. The only major remaining geographic restriction relates to the taking of deposits, and even here we can list a lot of exceptions. There are grandfathered situations in which individual banks or holding companies operate on an interstate basis. In addition several savings and loan associations branch interstate and some savings banks have acquired savings and loans in other states.

Several states permit selective out-of-state entry and there is pending legislation in several others that would expand the list. Several bank holding companies have acquired minority stock positions in depository institutions in other states, essentially positioning themselves for the time when either the Douglas or McFadden restrictions are removed.

The Garn-St Germain Act permits interstate acquisitions of failing depository institutions if they meet size and other criteria. In a few states legislation is pending that would permit interstate acquisitions to accommodate selected problem situations.

Even without interstate branching or the control of depository institutions on an interstate basis, retail deposit markets have become less insulated from out-of-state competition. Money market funds showed us that retail money could be attracted through the mail when rates offered were high enough, and the deregulation of deposit rate ceilings has increased the ability of depository institutions to penetrate deposit markets without a physical presence.

All of this suggests that geographic restrictions are becoming less important and currently play much less of a role in insulating local markets from competition than they have in the past. There are inequities in present arrangements. In some instances devices to get around geographic restrictions or efforts by institutions to position themselves for the future are probably wasteful.

Geographic restraints have in the past served as a proxy for antitrust enforcement; that is, by limiting the areas in which banks were permitted to expand, the restraints fostered a larger number of competitors. As the restraints are dismantled, there will be a tendency toward greater concentration of financial resources in fewer hands.

Although some additional concentration would not be alarming, we believe significant additional concentration should be avoided. It would not only be philosophically objectionable to have the bulk of our nation's financial resources controlled by a handful of institutions, it would pose significant risks to the insurance system as exposures become larger and less diversified.

Although a persuasive argument can be made that the country would be better served if Congress acted to remove geographic restraints on the activities of depository institutions, the FDIC's official and unofficial position on this score is one of neutrality. Current antitrust laws appear inadequate to deal with potential concentration in the financial services industry, particularly if the geographic barriers should be dismantled. We are required to focus entirely on narrow geographic and product markets; overall concentration and the structural effects of combinations are not adequately considered. Too often this results in a rigid posture with respect to the merger of two small banks in the same community while, at the same time, we permit the nation's largest financial conglomerates to make one major acquisition after another. We believe this situation should be corrected.

Control of Excessive Risk Taking

Since the FDIC is an insurance agency and, therefore, bears the direct cost of excessive risk taking, some would argue that we should minimize our exposure to risk by restricting what banks can do. We disagree.

It is clear that the banking environment has undergone a dramatic change over the past decade. Recessions have been more frequent and severe, and interest-rate volatility has been high relative to historical standards. Deposit interest rate controls have been almost completely dismantled in response to market pressures. Product distinctions among banks, S&Ls and other intermediaries are barely discernible. Restrictions on entry and expansion have been eased.

Such changes bring to the forefront a critically important set of questions. How, in the absence of rigid, government-imposed restrictions on competition, do we control destructive competition and excessive risk-taking? How do we insure that deposits flow to the vast majority of banks that are prudently operated rather than to the marginal banks that are willing to make the highest risk loans and pay the highest rates for deposits?

There are two options. We can adopt countless new laws and regulations to govern every aspect of bank operations and hire thousands of additional examiners to monitor and enforce compliance. Or, we can seek ways to increase marketplace discipline.

The FDIC clearly prefers the latter approach. Let me outline some steps we are considering or implementing to achieve this objective.

Charges for Additional Examinations

Currently the FDIC does not charge banks for the cost of examinations. In a sense, however, all banks directly bear part of the cost of examinations since any supervisory expenses are reflected in lower premium rebates. Thus, to the extent that problem institutions require more frequent examination, an unfair burden is placed on all banks.

We feel it would be appropriate to charge banks for any above-normal cost of supervision. In addition to being more equitable, such a plan would create a small incentive for banks to promptly correct their problems.

Risk-Related Deposit Insurance Premiums

In addition to charging for extra exams, it would be desirable to price deposit insurance to reflect the risk of individual banks. This is why we have recommended (in the insurance study mandated by the Garn-St Germain Depository Institutions Act of 1982) adoption of risk-related deposit insurance premiums.

The current system of flat-rate assessments has two major flaws. First, it does nothing to discourage risk-taking, thereby forcing bank regulators to issue explicit regulations designed to control bank risk. Second, it is simply not fair that prudently managed banks should pay the same price for deposit insurance as those banks that pose a much greater threat of failure.

We have suggested that banks be divided into three risk classes based upon various well established measures of bank risk. The premium structure would be altered by changing the method by which we calculate our assessment rebates. Banks rated high risk would receive only half of their normal rebate and the very high risk banks would get no rebate. For those banks rated normal -- and this would include the vast majority of all banks -- nothing would change; they would receive their entire rebate.

This proposal is a modest one. The variation in premiums between the high risk and normal banks will be relatively small. It is not likely this system will go very far toward discouraging risk-taking; however, it is more equitable, and it is a step in the right direction.

Once we institute a premium structure based upon risk, through experience we may discover ways to refine it and make it more effective. While we are in favor of adopting and implementing a risk-related premium system, information and data problems will likely prevent us from ever measuring risk so precisely that we can set insurance premiums to entirely compensate for the level of risk exposure in a particular institution. Therefore, if we are to properly control risk without the issuance of excessive regulations, we must rely upon sources of discipline outside the FDIC.

Reducing De Facto Insurance Coverage

Although the explicit coverage under our deposit insurance system is limited to $100,000, in practice we have for years been providing implicit 100 percent coverage for depositors and other creditors at most banks, particularly the larger ones. This has resulted from our practice of merging failed banks into other banks. Under current law, we are required to make all general creditors whole when we arrange a merger (or a purchase and assumption transaction).

We have had a strong preference for handling bank failures through mergers. It is ordinarily the least expensive and least disruptive method. We nevertheless abhor the side effect of providing 100 percent deposit insurance coverage; we are convinced it has eroded marketplace discipline and provided larger banks a substantial competitive advantage.

Prior to the failure of Penn Square National Bank, many believed the FDIC would never pay off depositors in a bank larger than $100 million. That episode has obviously caused people to raise their estimate of the size limit, but most still believe there is a limit beyond which we will not go.

As a practical matter, they may be right. It is not, as some people think, a matter of cost. The percentage of insured deposits in most large banks is comparatively modest and paying them off would not be prohibitively expensive. The problem is that billions of dollars of uninsured funds would be tied up for years in a bankruptcy proceeding, possibly causing severe repercussions throughout the economy.

In order to provide uninsured depositors and other creditors with the proper incentive to monitor bank risk, their risk exposure must be increased. We would suggest two methods whereby this can be accomplished.

Modified Payoff. Under this plan, the FDIC would take two actions upon a bank's closing and the establishment of a receivership. First, insured depositor claims would be satisfied as rapidly as possible as is the current payoff practice. Second, an "advance" of additional funds to all remaining valid claimants would be made, equivalent to the FDIC's estimate of the total value of bank assets to be recovered in liquidation.

This plan would have the beneficial effect of facilitating a payout, especially for larger institutions, since the potentially large volumes of assets and uninsured creditors will not be frozen in bankruptcy proceedings for a long period of time. Additionally, since it is envisioned that the insurance deposit settlement and the additional "advance" of other funds could be transfered to an operating institution, most of the benefits of the traditional purchase and assumption transaction could be retained.

Coinsurance. A variation of the modified payoff approach would be to provide coinsurance on deposits over the present insured limit. For example, balances up to $100,000 would be fully insured, with amounts above the limit provided 75 percent coverage (*i.e.*, the depositor provides "coinsurance" on 25 percent of the excess balance). The workings of this system would be basically the same as the modified payoff alternative discussed above, except that depositors would know the proportion of uninsured funds that would be immediately available if the bank should fail.

Both approaches -- the modified payoff and the coinsurance plan -- would expose large depositors to some risk of loss (in the typical case they might ultimately lose 10 percent or so of their balances over $100,000), but would make most of the funds immediately available so as to limit the economic repercussions of the failure. Depositors would be given an incentive to select a bank on some basis other than its size or the rate of interest it pays on deposits. Depositors would begin to inquire about such matters as capital adequacy, risks in the loan portfolio, insider dealings and liquidity.

Depositor Preference

In addition to the modified payoff there are other things that can be done to enhance market discipline. At the present time, depositors are considered general creditors in bank liquidations except in a few states in which their claims on the assets of a failed state-chartered bank are specifically preferred over those of other general creditors. Significant benefits would derive from statutorily providing for a depositor preference from the standpoint of increasing market discipline since the potential loss exposure of selected creditors would be increased. In addition, it would facilitate the use of the modified payoff option in handling bank failures.

Thus, if depositors were preferred to general creditors, the latter would have to be more concerned about with whom they do business. We believe that such increased concern would be appropriate and would act as a check on bank risk in some areas.

Should this approach be adopted, however, it would be necessary to spell out carefully through legislation who would be preferred. On balance, we believe it would improve the fairness of the system and increase market discipline.

Capital Standards

Finally, we may wish to reexamine our capital adequacy standards. Economic and financial events of the past several years have demonstrated the importance of a sound net worth position to a firm's ability to withstand protracted adversity and uncertainty. To the extent deregulation increases uncertainty, the need for a strong capital base in financial institutions takes on even greater significance. Subordinated debt, while not contributing to a bank's solvency, could play an important role in not only protecting depositors but in increasing market discipline.

From the standpoint of market discipline, subordinated debt affords certain advantages over deposits. Subordinated lenders are apt to be more sophisticated and comfortable in evaluating credit risk. Whereas most uninsured deposits mature within a few months or can be withdrawn on demand, subordinated lenders typically are in a very different situation. Once having made the loan or investment, they generally cannot flee during adversity. They have to view borrower (bank) operations from a longer-term perspective.

Banks could be required to maintain a minimum protective cushion to support deposits, which could be met by the use of a combination of equity and subordinated debt. Smaller banks that already have a high equity ratio or might have limited access to debt markets might choose a higher proportion of equity to meet the minimum. Larger banks that are well-rated might be able to obtain as much as one half of this cushion from debt markets in the form of subordinated funding. As banks grow they would be required to add proportionally to their "capitalization." Rapidly growing banks would have to go to the market frequently to expand their cushion and to refinance maturing issues. Thus, they would be exposed periodically to the results of their performance and, possibly, to the reactions of rating services.

Depositors would be significantly insulated because of the increased size of the protective cushion. Yields on issues traded in the secondary market would also provide them with information on the market's valuation of their institution. Large institutions with good internal controls and audits and a reasonable degree of agency monitoring should provide a sufficient cushion so that significant depositor losses would not occur frequently, even when banks fail.

The FDIC is not prepared to endorse this concept at this time. A number of details would have to be worked out before it could be implemented, but it appears to warrant consideration in addition to, or in lieu of, the modified payoff and coinsurance proposals considered above.

Public Information

Irrespective of the methods used to enhance market discipline, it is clear that the marketplace cannot perform its proper function without an adequate amount of information. Thus, we have decided to make public the new call report data on interest-rate sensitivity and nonperforming loans, and we are considering additional disclosures covering such matters as insider-lending practices and enforcement actions. This should help turn the spotlight on marginal, high-risk banks. We believe this will deter unsound banking practices and destructive competition. If problems nonetheless arise, troubled banks will either correct them promptly or fail more quickly, causing less damage.

It may seem harsh, but we cannot coddle marginal banks. To do so would undermine the vast majority of banks that are operating prudently by making sound loans, maintaining adequate capital ratios and paying reasonable rates for their deposits.

Regulatory-Supervisory Structure

Before concluding, Mr. Chairman, I would like to make some comments about the future structure of depository institution regulation. An examination of the current regulatory system reveals many disparities and anomalies. For example, state banks are burdened by two layers of regulation while national banks operate with only one. Savings and loans operate under vastly different rules from those applicable to commercial banks even though they now have commercial lending and checking account authorities. In our opinion, financial institutions with essentially the same powers should be regulated in essentially the same way.

Parent bank holding companies are examined and regulated by the Federal Reserve System while the lead bank is usually examined and regulated by a different agency. This results in needless duplication of effort and makes effective supervision more difficult.

There appear to be inconsistencies and needless duplication in other areas of bank regulation. Mergers are subject to antitrust review by both the banking agencies and the Justice Department. The banking agencies enforce the securities laws with respect to banks while the Securities and Exchange Commission has responsibility for bank holding companies and other businesses. Also, the banking agencies enforce Truth-in-Lending and other consumer laws with respect to banks, while the Federal Trade Commission oversees nonbank firms.

Merging the FDIC and the FSLIC Insurance Funds

An important first step toward the rationalization of the regulatory system would involve the merger of the FDIC and the Federal Savings and Loan Insurance Corporation. Similarities of objectives and functions for the deposit insurance agencies and a growing similarity in banks and thrift institutions support the notion of a single fund as a logical alternative to the present framework. The future of the financial services industry will require a larger, better-diversified insurance fund and greater flexibility in dealing with troubled or failed institutions, including cross-industry takeovers. Interindustry mergers can be expected to increase as banks and thrifts seek access to each other's markets. Loose affiliations between banks and savings and loans are becoming more and more common, making effective supervision difficult.

Merging the funds will provide for less public confusion and greater public confidence in the deposit insurance system, and foster more uniformity of supervision, particularly with respect to capital adequacy and disclosure requirements. Additionally, a merger of the insurance funds would facilitate the separation of the role of deposit insurance from chartering and regulation.

The present system whereby chartering, regulation and supervision are used to promote all aspects of an industry (individual institutions, housing and depositors), while at the same time these vehicles are used to protect an insurance fund, involves inherent conflicts. A consequence could be the subordination of safety and soundness considerations to those of promotion. The responsibility of an insurer is, and should be, singular -- stability of the system through the safe and sound operation of individual institutions and the prompt resolution of problems.

There frequently is, and should be, a healthy tension between the insurance and regulatory functions. The best way to achieve this is through a legal separation of the agencies performing these distinct functions. While having the chartering and insurance functions housed in a single agency may provide some flexibility for dealing with crises, such as have been experienced in the thrift industry during the past two years, it removes the discipline provided by a system of checks-and-balances. During the past two years, the FDIC has handled more than 60 bank and thrift failures. These failures were dealt with swiftly and effectively, notwithstanding the absence of a chartering power. Indeed, the fact that the handling of those failures was subjected to review by a separate chartering authority imposed an important discipline on the insurer with respect to both identifying and resolving the problems.

Supervisory Framework

A merger of insurance funds has implications for the structure of the supervisory framework and should be viewed as part of a comprehensive plan to more rationally define the federal insurance and regulatory process.

The federal financial regulatory structure could be consolidated to combine the functions of the Federal Home Loan Bank Board, the Federal Reserve and the Comptroller into a single independent agency headed by a board. That agency would issue charters, act on corporate applications, and supervise all federally-chartered banks and thrifts and holding companies. These functions would remain with the states for state-chartered banks and thrifts.

The FDIC would have the authority to conduct examinations, require reports, and take enforcement actions with respect to any insured institution or its affiliates, although it would focus its attention on problem and near-problem institutions. The FDIC would not have regulatory authority with respect to branches, mergers, trust powers and the like. An examination could be made by the FDIC whenever necessary to determine the condition of an institution for insurance purposes. Under this program, the FDIC would concentrate on financial institutions with safety and soundness problems and examine well-rated institutions infrequently -- under a sampling program that would cover perhaps ten percent per year. The examination of a portion of well-rated institutions would provide the FDIC with information to judge the effectiveness of the chartering agencies' supervision and rating systems, provide training for new examiners, and diminish the automatic assumption that an institution is in trouble because of the FDIC's presence.

Other regulatory activities currently lodged in the banking agenices and the Federal Home Loan Bank Board could be reorganized along functional lines. For example, the Securities and Exchange Commission could be given exclusive jurisdiction over all securities matters relating to banks and thrifts (it now exercises such jurisdiction over holding companies); the Justice Department could assume sole responsibility for antitrust enforcement; and the Federal Trade Commission could enforce compliance with consumer laws such as Truth-in-Lending.

Reorganizing the federal regulatory framework would result in administrative cost savings in the form of reduced support staffs and consolidated regional offices. This consolidation should reduce travel expenses and diminish some of the informational problems that exist today. More important than any cost saving, however, is the fact that supervision of federally-insured banks and thrifts would be vastly improved.

The fact is that the current, fractionalized system of regulation and insurance for banks and thrifts is increasingly inefficient, ineffective and inequitable. Assuming it was justified when created 50 years ago, events have passed it by and it has outlived its usefulness. The system is in urgent need of a major overhaul.

The overall supervisory structure that might be formed as a result of the reorganization of the federal regulatory system has implications for the proper role of the Federal Reserve. In general, the issue is whether the regulation of banks and bank holding companies is necessary to conduct monetary policy. The argument that the Federal Reserve needs general supervisory authority over 1,000 commercial banks (out of a total of some 14,400) and needs to regulate and supervise bank holding companies to augment or enforce monetary policy is not persuasive. Indeed, many informed observers perceive the potential for serious conflicts between bank supervision and the conduct of monetary policy.

The Federal Reserve could continue to have access to bank data and information through representation on the Board of Directors of the FDIC and the new regulatory agency and, through this, would gain more direct access to data on other financial institutions, an increasingly significant factor as thrifts begin exercising more bank-like powers.

Mr. Isaac. For most of the last half century, competition in financial services was tightly controlled. Both price and product competition were curtailed by law. Entry into the business was carefully regulated, as was expansion. It was rare for a bank to fail.

All this has changed. The current economic climate is anything but benign. Deposit interest rate controls have been almost completely dismantled. Product distinctions among banks, savings and loan institutions and other intermediaries are barely discernible. Restrictions on entry and expansion have been eased.

The new environment offers many opportunities for well-managed banks of all sizes. At the same time, it presents many challenges for our regulatory system. How, in the absence of rigid Government restrictions, do we control destructive competition and excessive risk taking? How do we insure that deposits flow to the vast majority of banks that are prudently operated, rather than to the marginal banks that are willing to make the highest risk loans and pay the highest rates for deposits?

We have two options. We can adopt countless laws and regulations and hire thousands of additional examiners to enforce them. Or, as the FDIC prefers, we can seek ways to increase marketplace discipline.

For the marketplace to perform its disciplinary function, it must have information. This is why we have decided to make public data on problem loans at banks and their vulnerability to interest rate changes. That is also why we are considering disclosing information on insider-lending practices and enforcement actions.

We are trying to turn the spotlight on marginal, high-risk banks. We believe this will deter unsound banking practices and destructive competition, and will benefit those banks that are operating prudently.

RISK OF LOSS ESSENTIAL TO MARKETPLACE DISCIPLINE

The other ingredient essential to marketplace discipline is the risk of loss. Although insurance coverage is limited to $100,000, in practice we have for years been providing implicit 100 percent protection for depositors and other creditors at most banks, particularly the larger ones.

This has resulted from our preference for handling bank failures through mergers, which are ordinarily less expensive and less disruptive than paying the claims of insured depositors. However, the side effects of providing 100 percent insurance coverage have been to erode market discipline and give larger banks a significant competitive advantage.

Before the Penn Square Bank failure, it was generally believed the FDIC would never pay off depositors in a bank larger than $100 million. That episode caused people to raise their estimate of the size limit, but most still believe there is a limit. As a practical matter, they may be right. It is not, as some people think, a matter of cost. The percentage of insured deposits in most large banks is comparatively modest, and paying them off would not be prohibitively expensive. The problem is that billions of dollars of uninsured funds could be tied up for years in a bankruptcy proceeding.

We have suggested two possible solutions to this problem in the deposit insurance study submitted to Congress pursuant to the Garn-St Germain Act. One approach may be to provide 100 percent coverage for the first $100,000 in deposits and a smaller percentage—say 75 percent—for all deposits over $100,000. A variation might be to pay, at the time of failure, the first $100,000, plus an amount equal to the estimated ultimate recovery on amounts more than the $100,000. The revised coverage would apply whether we paid off depositors or arranged a merger.

In both cases, enough deposits would be made immediately available to minimize the economic repercussions, but there would be some risk of loss. We would not provide a complete bailout for the largest creditors. This would provide customers an incentive to select the soundest institutions, not just the largest ones or the ones that pay the highest interest rates.

In addition to the need for these and other possible reforms in the insurance system, such as risk-related premiums and a depositor-preference statute, both of which we've recommended, the inefficiencies and inequities in the regulatory system should be addressed.

Why, for example, should State banks be burdened by two layers of regulation while national banks operate with one? How do we rationalize a system whereby the Federal Reserve supervises a parent holding company when a different agency has responsibility for the lead bank in the system? How can we justify a separate regulatory system for savings and loans now that they have commercial lending and checking account authorities? Why should mergers be subject to antitrust review by both the banking agencies and the Justice Department? Why should the banking agencies enforce the securities laws for banks when the Securities and Exchange Commission has responsibility for bank holding companies and other businesses? Why should the banking agencies enforce consumer laws with respect to banks, while the Federal Trade Commission oversees nonbank companies? Why is it permissible for a securities firm to own a bank, but not the reverse? How do we justify the ownership of federally insured savings and loan associations with full banking powers by businesses such as Sears and National Steel, while prohibiting a bank from owning a retailer or steel company?

REGULATORY SYSTEM NO LONGER RATIONAL

A short answer to these and other similar questions is that the regulatory system is no longer rational; the world has passed it by. This condition needs to be addressed through comprehensive reform.

First, we need to redefine the term "bank" and reconsider the activities in which it or its affiliates may engage. It may be appropriate to define a bank as any institution that offers any type of federally-insured deposit. In our opinion, a bank should be permitted to engage, either directly or through a subsidiary, in the full range of financial services, including securities, real estate, travel agency, insurance, and data processing activities. Any company solely engaged in these activities should be permitted to own or affiliate with a bank or savings and loan and any company engaged in impermissible activities should not.

Second, the financial agencies at the Federal level should be consolidated and regulation should be organized along functional lines. The regulatory functions of the Federal Home Loan Bank Board, the Federal Reserve and the Comptroller of the Currency might be consolidated into an independent agency headed by a board. That agency would license and regulate all federally-chartered banks and savings and loans and their holding companies. State-chartered institutions would be licensed and regulated by their State authority, preserving our dual or State-Federal banking system. The FDIC would remain a separate, independent agency with insurance (but not regulatory) responsibilities for all State- and federally-chartered banks and savings and loans. It would have the right to examine, require reports from, and take enforcement actions against any insured institution or its affiliates.

Finally, securities regulation with respect to banks, savings and loans and holding companies would reside exclusively in the SEC. Antitrust enforcement would reside exclusively in the Justice Department. Consumer compliance matters would reside exclusively in the FTC.

If we have the wisdom and courage to tackle these issues, I believe we can look forward to a strong, profitable and responsive banking system. It will be a system in which well-managed institutions of all sizes will be able to compete on an equal footing and prosper. To stand pat will inevitably lead to more and more regulation and bureaucracy. The largest institutions will continue to grow simply because they are big. The unregulated will thrive at the expense of the regulated.

Mr. Chairman, I will be pleased to respond to any questions you or members of the committee may have.

The **Chairman**. Thank you, Mr. Isaac.

Mr. Conover.

STATEMENT OF C. TODD CONOVER, COMPTROLLER OF THE CURRENCY, U.S. DEPARTMENT OF THE TREASURY

Mr. **Conover**. Mr. Chairman, I have a longer statement that I would like to have entered in the record.

The **Chairman**. It will be included in the record.

[Complete statement follows:]

STATEMENT OF

C. T. CONOVER
COMPTROLLER OF THE CURRENCY

Before the

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

April 27, 1983

Mr. Chairman, members of the Committee, it is a pleasure to offer my views on the competitive structure of the financial services industry. These views are not necessarily those of the Administration.

Extremely important issues confront the banking industry, the financial services marketplace, and the consuming public. These issues are not new; in the past, several major studies have produced many recommendations for reform that have yet to be implemented. Recent marketplace developments make the need for change even more pressing. There are some specific actions Congress ought to take to ensure a healthier, more competitive financial system.

PREVIOUS RECOMMENDATIONS FOR CHANGE

The Glass-Steagall Act was passed 50 years ago. The McFadden Act was enacted six years earlier. Together these statutes have become significant geographic and product restrictions on the banking industry.

As early as 1961, these competitive constraints on banking were recognized as harmful. In that year, the Report of the Commission on Money and Credit stated:

> A multitude of regulations promulgated by the states and the federal government now govern the kind and amounts of assets that commercial banks, savings banks, and savings and loan asociations may hold. The restrictiveness of these regulations and their unequal application have handicapped these institutions in directing their lending into areas and uses where more profitable opportunites exist. The regulations also often discourage initiative and competition, which in turn reduce the contribution of the private financial institutions to economic growth. The financial system would be better able to adapt to the now unforeseen future credit needs of the economy if it were granted greater flexibility in investing. Safeguarding small depositors and the money supply, until now a main objective of investment regulation, may be better accomplished in other ways. (p. 161).

A decade later, the President's Commission on Financial Structure and Regulation, known as the Hunt Commission, produced a persuasive report that stressed the need for a more competitive financial system. The Commission's recommendations were broad-based and included removing Regulation Q, relaxing geographic restrictions, and permitting depository institutions to offer mutual funds, underwrite revenue bonds, and engage in insurance activities. The philosophy of the Hunt Commission can be summarized in the following statement:

> The Commission's objective, then, is to move as far as possible toward freedom of financial markets and equip all institutions with the powers necessary to compete in such markets. Once these powers and services have been authorized, and a suitable time allowed for implementation, each institution will be free to determine its own course. The public will be better served by such competition. Markets will work more efficiently in the allocation of funds and total savings will expand to meet private and public needs. (p. 71).

The report also emphasized that the needed restructuring should not be implemented in a piecemeal fashion:

> The recommendations are interrelated and the Commission urges that they be considered as a package, even though some of the proposed changes, if enacted separately, would improve the financial system. The Commission believes that piecemeal adoption of the recommendations raises the danger of creating new and greater imbalances. (p. 9).

In 1975, the House Subcommittee on Financial Institutions undertook a major review of the financial services industry known as the Financial Institutions and the Nation's Economy (FINE) Study. Recommendations included removal of Regulation Q, permitting banks to underwrite revenue bonds, and the relaxation of interstate branching restrictions. The underlying philosophy of the recommendations, like that of the Hunt Commission, was that the strength of the financial system depends upon the ability of institutions to be more competitive:

> A coordinated approach is needed to strengthen our depository institutions. Artificial ceilings on interest rates paid to depositors reduce the incentive for Americans to save, discriminate against small savers, and have not succeeded in preventing disintermediation. All forms of depository institutions need broader and clearer powers with respect to both sources and uses of funds. More competition, and better informed depositors, borrowers, and investors, could provide an appropriate bicentennial for Adam Smith. (p. 1).

In January, 1981 the Treasury Department released the Report of the President: Geographic Restrictions on Commercial Banking in the United States, which concluded that:

> ... the McFadden Act ... and [the Douglas Amendment] are increasingly ineffective, inequitable, inefficient and anachronistic, and that the existing *de facto* system of interstate banking should be *ratified* and further liberalized through a phased relaxation of current geographic restraints. (p. 17).

These major reviews of the financial structure in the 1960s, 70s, and 80s produced numerous, consistent recommendations for change. Those recommendations were grounded in the belief that many of the restrictions on banks that had been enacted decades earlier were no longer serving a valid purpose, and that the consuming public would benefit directly if they were relaxed. This assertion remains true today. Unfortunately, with the exception of the phase-out of Regulation Q, little substantive deregulation of banking has occurred through Congressional action.

MARKET AND LEGISLATIVE DEVELOPMENTS

Ongoing marketplace and legislative developments heighten the need for further deregulation. In the decade since the Hunt Commission boldly stated that banks were too heavily regulated, the environment in which financial institutions operate has continued to change dramatically. Both technological and economic forces have provided the incentive to change, and less regulated financial institutions have led the trend toward innovation. Hampered by regulation, banks have been less able to respond innovatively.

Technological and Economic Change

Rapid technological advances have streamlined financial transactions and greatly enhanced the ability of banks and other institutions to deliver financial services. The year the Hunt Commission Report was released, automatic teller machines (ATMs) were a relatively new phenomenon, with just over 1,000 installed across the country. By 1981, there were over 19,000 ATMs, and projections indicate that by the end of this year, there will be over 40,000 nationwide. Many of these new installations are part of interstate networks that are bringing together different types of institutions in diverse geographic areas.

Coincident with the advent of this technological revolution were changes in the economic environment. Unprecedented high and volatile interest rates of the late 1970s and early 1980s made it difficult for depository institutions, subject to rate regulation, to attract funds from increasingly rate-sensitive depositors.

Innovations by Non-Depository Financial Service Firms

Armed with new technological capabilities, competitors not subject to interest rate ceilings, geographic barriers, and product constraints found new market opportunities. Money market funds experienced rapid growth from under $2 billion in 1974 to well over $200 billion in 1982, by offering a market-rate, liquid, transaction instrument.

In 1977, Merrill Lynch introduced the Cash Management Account, a more far-reaching product innovation that combined a money market fund, a debit/credit card, and brokerage services. In only five years this account has gained phenomenal public acceptance, serving nearly one million customers with $13 billion in their CMA accounts. Other brokerage houses quickly followed suit with similar asset management accounts. Even broader product packaging is occurring in such newly merged financial firms as Shearson/American Express; Sears/Dean Witter/Allstate Savings/Allstate Insurance/Coldwell Banker; and Prudential/Bache.

These nonbank financial service firms, many of which are offering essentially banking services, also enjoy the ability to operate nationwide. The geographically diverse customer base and branch network of Sears, for example, gives it marketing latitude unavailable to banks. Sears has over 2800 sales outlets and related real estate and brokerage offices in 50 states. Sears owns the 24th largest savings and loan association with $3.5 billion in assets. It also has the second largest number of credit card accounts, over 24 million, and the third largest volume of outstanding credit card balances, nearly $7 billion.

Bank Responses to Competition

Banks and thrifts sought to respond to this new competition by structuring their corporate organizations and limited array of permissible products in complicated ways. In order to avoid deposit rate ceilings, banks and thrifts began introducing hybrid accounts such as retail repurchase agreements, sweep accounts, and complex packages of savings and checking accounts combined with low rate deposit loans.

Fortunately, some of the more complex and costly product responses to high interest rates are largely a thing of the past due to the current phaseout of Regulation Q, and particularly the establishment of the Money Market Deposit Account. However, the lesson from these events -- that the marketplace will find a way to meet consumer demands -- has not been learned. Many product and geographic restrictions still exist for banks, again resulting in complex and costly responses.

Loan production offices, for example, enable banks to provide some services on an interstate basis. Separate Edge Act offices permit other services to be offered without geographic restriction. Consumer finance offices and ATM networks can offer still others. More recently, the advent of deposit brokering through securities firms has even made it possible to gather deposits across state lines. However, interstate expansion in traditional ways, through brick-and-mortar offices, is still effectively limited for banks. The consumer pays the price of the inconvenience caused by such fragmented delivery of services.

Forcing financial institutions to follow such circuitous routes to meeting the public's needs serves no useful purpose. It results only in lost benefits to the public.

Changes in Bank Regulation

For the most part, legislative and regulatory changes have been slow in coming despite these marketplace developments. After major lobbying by consumer groups, Congress in 1980 directed the phaseout of deposit interest rate ceilings. Similarly, because local usury ceilings had become so far out of line with market interest rates, with serious consequences for affected consumers and institutions, a temporary federal preemption of state usury laws was passed in 1980. A more permanent preemption is now under consideration.

Congress has also broadened the asset powers of savings and loan associations, savings banks, and credit unions. Thrifts can now offer as broad a range of services as commercial banks. Moreover, they are subject to less stringent geographic limitations. And their holding companies and service corporations have substantially greater powers than similar banking organizations.

Actions at the state level also signal the recognition of legislators that marketplace changes are requiring legislative responses. Beginning with NOW accounts in the mid-1970s, state legislators have shown a willingness to be in the forefront of the deregulatory effort. Recently, South Dakota and Delaware enacted laws allowing out-of-state holding companies to charter limited-purpose banks in their states. In addition, South Dakota now permits state-chartered banks to engage in all facets of insurance activities. Maine, Minnesota and Delaware are currently considering legislation authorizing such activities. In California, a law will soon go into effect which authorizes expanded securities and real estate activities.

Illinois, Pennsylvania and West Virginia have greatly liberalized intrastate geographic restrictions, and serious legislative efforts are underway in other states. Alaska now permits out-of-state institutions to own banks within its borders, and New York has enacted reciprocal interstate legislation. A major regional interstate experiment is taking shape in New England. Laws permitting emergency interstate mergers of troubled institutions have been enacted at both the state and federal level, most recently in the state of Washington, where the largest banking merger in U.S. history is now pending.

These legislative developments and the marketplace changes of the last few years have had a major impact on the functioning of the financial industry. Every time product and geographic constraints have been relaxed or circumvented, the response of the marketplace has been swift, significant, and to the benefit of the public. These responses validate the recommendations of the Hunt Commission and FINE Study. Unfortunately, further deregulation of the banking industry does not seem imminent in our national legislature.

OPPOSITION TO DEREGULATION

The most striking aspect of the continued failure to legislate substantive deregulation is that large segments of the financial services industry itself have been a primary source of resistance. Preventing market entry is a classic means of protecting the profits of those already in the market. Thus, some bankers oppose the removal of restrictions on entry into their product and geographic markets. Those in the securities, insurance, and real estate businesses oppose the removal of restrictions that serve to protect them from competition. In fact, each segment of the financial services industry benefits in some way from the restraints on competition provided by the Glass-Steagall Act, the McFadden Act, and the Bank Holding Company Act. For the past 50 years each segment has been largely successful in supporting the retention of competitive restraints.

The primary beneficiary of deregulation of the financial services industry would be the financial services customers -- individual consumers, small businesses, and large corporations.

As I noted earlier, the benefits to consumers of a more competitive financial marketplace were recognized as early as 1961 by the Commission on Money and Credit, and noted even more strongly by the Hunt Commission and subsequent studies.

The spectacular growth of the newly-authorized Money Market Deposit Account demonstrates that when banks and thrifts gained the ability to offer a competitive product, they met a demand that was not entirely satisfied by other financial services providers. Consumers demand competitive products, and they are best served when competitors are free to respond to their demands.

Additional beneficiaries from the removal of barriers to competition, of course, would be the numerous banks, thrifts and other financial service firms that are prepared and eager to respond to the marketplace if permitted. Long-term competitive viability, they recognize, depends on the ability to respond to market changes without severe constraints on product or geographic decisions.

RECOMMENDED PRODUCT AND GEOGRAPHIC DEREGULATION

My Office still maintains its long-held belief that the banking industry is too heavily restricted. We supported the removal of Regulation Q, and we continue to support the elimination of geographic barriers, and expansion of product powers for depository institutions. These restrictions are anticompetitive, create competitive imbalances, penalize the public, and ought to be removed.

Banking organizations should be allowed to offer a broad array of financial services, specifically including insurance underwriting and brokerage, securities underwriting and brokerage, and real estate brokerage. I also believe they should be able, with limitations, to engage in real estate development and to make equity investments in real estate.

Banking organizations ought to be able to offer these services over an unrestricted geographic range. There are many steps that can be taken to liberalize branching powers. An immediate, highly desirable step would be to change the definition of a branch to exclude unmanned banking facilities. Consumers would gain the added convenience of being able to make relatively simple transactions at ATMs, while banks in the area would still have the competitive advantage of offering full-service banking. Additionally, states should be encouraged to permit statewide branching. As soon as is feasible, the restrictions imposed by the McFadden Act and the Douglas Amendment to the Bank Holding Company Act should be eliminated. If a transition period is required, interstate expansion could be allowed on a regional basis. To that end, I applaud the regional experiment that has been proposed in New England. Similarly, metropolitan areas that cross state lines would also benefit greatly from unrestricted bank branching.

Limiting Banks' Exposure to Risk

Product and geographic restraints on banks must be relaxed, because banks must be able to meet the needs of the marketplace in order to thrive, and because the consumer will benefit. Any restrictions on banks' market activities that are retained should be justified by legitimate public concerns, not the protection of special interests. Chief among those concerns is maintaining confidence in our payments system and avoiding a threat to our money supply. Because of these concerns, we try to insulate banks' capital and liquidity from certain risks in order to maintain banks' solvency.

Other traditional public policy concerns are that credit be allocated based on arms-length, marketplace considerations rather than extended preferentially to insiders or affiliates, and that undue concentrations of economic power be avoided. These concerns have led Congress to carefully separate banking and commerce.

Our task is to devise ways of expanding banking activities to benefit the public, while meeting these public policy concerns. It is important to note that these concerns apply equally to any organization that offers banking services, regardless of its legal form. Therefore, since thrift institutions may now engage in the key bank activities that give rise to these concerns (transaction accounts and commercial lending), any structure that we devise ought to apply equally to banks, savings and loan associations and savings banks.

The expansion of bank activities through the holding company vehicle with appropriate safeguards is a good way of expanding bank powers within these public policy constraints. This is the essence of the Administration's bank holding company proposal submitted last year. I support this approach.

Nonbank Banks

Similarly, various organizations to which my Office has issued charters are able to operate unconstrained by the product and geographic restrictions of the Bank Holding Company Act. By limiting their activities to retail banking and not making commercial loans, these so-called "nonbank banks" avoid the threats posed by the mixing of banking and commerce, yet afford consumers the benefits of expanded services. Such banks can be owned by holding companies that engage in a variety of other financial services, including insurance, real estate, and stock brokerage. Such organizations may also engage in non-financial activities.

The bank, however, is effectively isolated from the risks of these other activities. The other activities are performed in subsidiaries of the holding company, not in the bank. The bank cannot own stock in its affiliates, nor (since it does not make commercial loans) can it lend to them. Thus, neither the bank's capital nor liquidity is directly placed at risk; insured deposits are not used to support other activities; and commercial loans are not made to affiliates on preferential terms -- they are not made at all. Thus, I believe the conflict of interest abuses that Congress has sought to prevent by separating banking and commerce are thereby precluded.

However, it is precisely these issues that Congress must debate. Yet the debate threatened to become too narrowly focused on the nonbank bank issue -- only a small part of the changes occurring in the financial services industry. For this reason, I declared a moratorium on charters for nonbank banks to allow Congress to fully debate the broader issues.

Market Discipline

Regardless of how we attempt to isolate a bank from new risks, however, whether in holding company subsidiaries or in other ways, the risk of banking as a business will increase. Such increased risk is inevitable, with or without further deregulation. The risk we choose if we do not deregulate is one of a deteriorating industry which lacks the flexibility to be respond efficiently to the changing marketplace. If we allow the industry to become more competitive, on the other hand, we will be allowing the banks themselves to choose the type of risk they assume. This is a necessary ingredient of a healthy and dynamic industry.

As statutory restrictions are removed, however, we cannot totally rely upon bank regulators to limit the risks posed by new activities. The discipline imposed by those statutes and by active supervision must be supplemented with the discipline of the marketplace. We must ensure that the marketplace has the information necessary to evaluate an institution's risk through adequate disclosure. We also must ensure that the banks themselves have adequate protection, in the form of liquidity and capital, to absorb the risk they are undertaking. And finally, our deposit insurance system should be modified so that each bank and its large, uninsured depositors share in the risks that the bank chooses to assume.

CONCLUSION

We recommend that Congress proceed with the comprehensive financial deregulation that has been advocated for over two decades by both Republican and Democratic administrations. The health and vitality of the banking system and the financial services industry depends upon creating a more competitive climate for all market players.

We caution against becoming distracted from this primary task by innovations taking place in the market, in the regulatory agencies, and in state legislatures. Developments such as state deregulatory actions and nonbank banks represent natural market responses to the imbalances existing in our system of financial regulation. They should be viewed as evidence of the need for moving ahead with further deregulation. It is time that we got on with the task ahead of us.

Mr. **Conover**. Mr. Chairman, members of the committee, it's a pleasure to offer my views on the competitive structure of the financial services industry.

Extremely important issues confront the banking industry, the financial services marketplace, and the consuming public. These issues are not new. They have been reviewed by several major studies—the Commission on Money and Credit in 1961, the Hunt Commission in 1971, the Fine Study of the House Committee on Financial Institutions in 1975, and the Treasury Department's 1981 report on geographic restrictions on commercial banking in the United States. These studies all recommended reforms to make the financial system more competitive, reforms that have yet to be implemented.

Recent marketplace developments make the need for change even more pressing. Both technological and economic forces have provided the incentive for change and less regulated financial institutions have led the trend for innovation.

There have been some changes in bank regulation at both the Federal and State level, but in general, banks have been significantly hampered in their ability to respond to market needs with innovative products and services.

FURTHER DEREGULATION OF BANKING NOT IMMINENT

Unfortunately, further deregulation of the banking industry does not seem imminent in our national legislation. The most striking aspect of the continued failure to legislate substantive deregulation is that the financial services industry itself has been a primary source of resistance.

The fact is that each segment of the financial services industry benefits in some way from the restraints on competition provided by the Glass-Steagall Act, the McFadden Act and the Bank Holding Company Act. And for the past 50 years, each segment has been largely successful in supporting the retention of competitive restraints.

The primary beneficiary of financial deregulation would be the public—individual consumers, small businesses, and large corporations. Customers demand competitive products and they are best served when competitors are free to respond to their demands. Other beneficiaries of deregulation include the numerous banks, thrifts and other financial service firms that are prepared and eager to respond to the marketplace if permitted. Their long-term vitality depends on their ability to respond to market changes unhampered by either geographic or product constraints.

My office continues to maintain its long-held belief that the banking industry is too heavily regulated. We supported the removal of regulation Q and we continue to support the elimination of geographic barriers and the expansion of product powers for depository institutions. These restrictions are anticompetitive, create competitive imbalances, penalize the public, and ought to be removed.

Banking organizations should be allowed to offer a broad array of financial services, specifically including insurance underwriting and brokerage, securities underwriting and brokerage, and real estate brokerage. I also believe they should be able with limitations, to engage in real estate development and to make equity investments in real estate.

Banking organizations ought to be able to offer these services over an unrestricted geographic range. A highly desirable first step would be to change the definition of a branch to exclude unmanned banking facilities. Consumers would gain the added convenience of being able to make relatively simple transactions at automated teller machines while banks in the area would still have the competitive advantage of offering full service banking.

Additionally, States should be encouraged to permit statewide branching. As soon as is feasible, the restrictions imposed by the McFadden Act and the Douglas amendment should be eliminated. If a transition period is required, interstate expansion could be allowed on a regional basis. To that end, I applaud the regional experiment that has been proposed in New England.

Product and geographic constraints on banks must be relaxed because banks must be able to meet the needs of the marketplace in order to thrive and because the consumer will benefit. Any restrictions on banks' market activities that are retained should be justified by legitimate public concerns, not the protection of special interests. Chief among those concerns is maintaining confidence in our payments systems and avoiding a threat to our money supply. Because of these concerns, we try to insulate banks' capital and liquidity from certain risks in order to maintain bank solvency.

Our other traditional public policy concerns are that credit be allocated based on arm's length marketplace considerations rather than extended preferentially to insiders or affiliates, and that undue concentrations of economic power be avoided. These concerns have led Congress to carefully separate banking from commerce.

Our task is to devise ways of expanding banking activities to benefit the public while meeting these public policy concerns. It is important to note that these concerns apply equally to any organization that offers banking services, regardless of its legal form. Therefore, since thrift institutions may now engage in the key bank activities that give rise to these concerns—that is, transaction accounts and commercial lending—any structure that we devise ought to apply equally to banks, savings and loan associations, and savings banks.

The expansion of bank activities through the holding company vehicle with appropriate safeguards is a good way of expanding bank powers within these public policy constraints. This is the essence of the administration's bank holding company proposal submitted last year. I support this approach.

Similarly, nonbank banks are able to operate unconstrained by the product and geographic restrictions of the Bank Holding Company Act. By limiting their activities to retail banking and not making commercial loans, they avoid the threats posed by the mixing of banking and commerce, yet afford consumers the benefits of expanded services. Such banks can be owned by holding companies that engage in a variety of other activities and such organizations may also engage in nonfinancial activities.

A bank, however, is effectively isolated from the risks of these other activities. The other activities are performed in subsidiaries of the holding company, not in the bank. The bank cannot own stock in its affiliates nor, since it does not make commercial loans, can it lend to them. Thus, neither the banks' capital nor liquidity is directly placed at risk. Insured deposits are not used to support other activities and commercial loans are not made to affiliates on preferential terms. They are not made at all. Thus, I believe the conflict of interest abuses that Congress has sought to prevent by separating banking and commerce are thereby precluded.

It is precisely these issues that Congress must debate. Recently, however, the debate threatened to become too narrowly focused on the nonbank bank issue, which is only a small part of the changes occurring in the financial services industry. For this reason, I declared a moratorium on charters for nonbank banks to allow Congress to fully debate the broader issues.

Regardless of how we attempt to isolate banks from new risks, however, whether in holding company subsidiaires or in other ways, the risk of banking as a business will increase. Such increased risk is inevitable with or without further deregulation. If we do not deregulate, we run the risk of having a deteriorating industry that lacks the flexibility to respond efficiently to the changing marketplace. On the other hand, if we do deregulate and allow the industry to become more competitive, we will be permitting the banks themselves to choose the type of risk they assume.

As deregulation occurs, however, we cannot totally rely upon bank regulators to limit the risks posed by new activities. Regulation must be supplemented with market discipline. The marketplace must have the information necessary to evaluate an institution's risk through adequate disclosure. The banks themselves must have adequate liquidity and capital to absorb the risks they are undertaking. And finally, our deposit insurance system should be modified so that each bank and its large uninsured depositors share in the risks that the bank chooses to assume.

In conclusion, Congress should proceed with the comprehensive financial deregulation that has been advocated for over two decades by both Republican and Democratic administrations. The health and vitality of the financial services industry depends upon creating a more competitive climate for all market players.

We caution against becoming distracted from this primary task by innovations taking place in the market, in the regulatory agencies and in the State legislatures. Developments such as State deregulatory actions and nonbank banks represent natural market responses to imbalances existing in our system of financial regulation. They should be viewed as evidence of the need for moving ahead with further deregulation. It is time that we got on with the task ahead of us.

That concludes my statement, Mr. Chairman. I'd be happy to answer questions.

The CHAIRMAN. Thank you very much.

MORATORIUM ON NONBANK CHARTERS

Gentlemen, both of you are very well aware of the process that I started 2 years ago and the difficulty of achieving the consensus on a bill that was finally enacted into law last October. Having gone through that process and taking 2 years to achieve it and then starting the process over again with a much larger slice to look at—many of the issues that are much more controversial than these we tackled before and during the process we have seen many changes take place—the ability of businessmen's minds to find loopholes and innovations is absolutely amazing to me. I'm staggered by the imagination of people out in the marketplace and I support that. I don't want to stifle it. It's part of the genius of our financial system. But, on the other hand, we may just be starting this process over again and probably looking at least at another year or two before you can expect Congress to act again in any broad, comprehensive way.

As you have mentioned, Todd, you have declared a moratorium on nonbank charters—it is only until next January. It further grandfathers applications that are already before you, one of which is rather large, the application by Dimensions for 31 banks in 25 States. I think you may have heard that the Secretary in the first day of these hearings suggested that you take a long, long time to consider those applications and at least until next January. That was his response.

But my question to both of you is, should that moratorium be broadened to try and hold everything in place until Congress does come to grips with it so that the marketplace isn't so distorted before we decide what directions we want to go? Should it be broadened to cover a change in bank control applications at the Comptroller's Office, the FDIC, the Fed and for S&Ls at the bank board? Is the moratorium broad enough?

Mr. Isaac, do you support the moratorium? Do you think it should go further?

Mr. ISAAC. No, I don't support the moratorium and I think it would be a serious mistake for the Congress to enact one. The applications that are occurring are perfectly legal under the law as written today. They show the direction in which the marketplace is heading. I don't think we ought to stand in the way of it. I think we ought to get on with the process of trying to come to grips with the changes through comprehensive reform. A moratorium will only buy more and more time to drag our feet and delay dealing with what we obviously have to deal with. I would like to keep the pressure on as much as possible to make the substantial reforms that are needed in our regulatory and insurance systems.

The CHAIRMAN. Well, I would agree with you in a nonpolitical world that we ought to move ahead, but look at the process that we went through. Both of you were intimately involved with me in that whole process and you know how difficult it was to get the job done in 2 years. So I would agree with you just from an initial starting point that we ought to move ahead. I don't like moratoriums. I don't like emergency pieces of legislation. I don't like 90-day extensions. I don't like any of those short-term, Band-Aid approaches, but that marketplace is changing so rapidly out there, at the end of 2 years where are we going to be? Then is our response simply going to be ratifying what has taken place in the marketplace as we have done so many times without really considering it and setting the policy directions? Can we afford to wait—even though I agree with you in principle, can we afford to wait 2 or 3 years and let the South Dakotas and the Delawares and Citicorps in and take advantage of those situations?

Mr. ISAAC. I would prefer that we not wait, that we move ahead with a comprehensive——

The CHAIRMAN. I do, too, but I'm trying to get you to address how Congress will act, and can we afford to stick with what we would prefer or do we need to try and hold a few things in place while we consider them thoughtfully?

Mr. ISAAC. We've got several different kinds of things that are occurring and it may be appropriate to look at them separately. In the first place, in the real political world, I don't see the Congress doing much of anything if we impose a moratorium except extending the moratorium. That's what really concerns me about a moratorium. It's just an easy way to put off the changes that must be made.

But there are different types of applications that are occurring. The one that is by far the most predominant is the application by financial—services firms to engage in a bank-type activity—a nonbank bank. For example, Dreyfus, American Express, and others of that sort. To me, those applications aren't controversial at all and they don't pose any public policy problems. I don't know on what basis we would impose a moratorium on them. They are perfectly legal under current law. It seems to me the burden is on those who want to stop these activities to prove what is unsound or unsafe or undesirable about them. I have seen no evidence that there are any major problems associated with those applications.

The CHAIRMAN. Nobody is suggesting that they are illegal. Certainly I have not. But under the definition of a bank, the two tests of a bank, if you buy one that doesn't do one thing and another one in another State that doesn't do something else, that certainly puts you in the banking business totally legally, but certainly not in the spirt of the law. There was certainly nothing illegal about money market mutual funds. They were legal. They fit all of the laws, but they took $200 billion out of depository institutions of this country purely legally and they could say all day long they were not in the banking business, they were not in transactions accounts, but you and I know that they were; and that was an issue we needed to address and we did.

Mr. ISAAC. But if these applications are not illegal—and we don't believe that they are—isn't the burden on those who would stop them rather than on those who would go forward with them to establish that there is something wrong with the applications—that there are safety and soundness considerations or antitrust considerations or some other issues involved that we should deal with? I have seen no persuasive evidence that applications that link up financial-services firms with banks present any serious issues in the safety and soundness, antitrust, or other areas. I don't know on what basis we would enact a moratorium to stop what is perfectly legal without a compelling case being made that there are some major public policy concerns or problems.

There are other applications that present some more serious questions. For example, the fact that Sears and National Steel own federally insured S&L's presents some very serious public policy issues that ought to be addressed. In the *McMann Furniture* case or the *Gulf and Western* case where we're dealing with nonfinancial firms, I perceive some very serious public policy issues that need to be addressed—potential conflicts of interest, safety and soundness issues, and antitust considerations

The FDIC has never approved such an application and does not intend to, and I believe it's well within the jurisdiction of the agencies to put a hold on that type of application until Congress resolves it. But in the cases of Dreyfus, American Express, and Prudential, I see no reason to impose a moratorium on those types of activities.

The CHAIRMAN. What about the Dimensions before we've really considered what we want to do with McFadden? What about the request of 31 banks in 25 States?

Mr. ISAAC. I gather the Comptroller has decided to drag his feet for a while on that one.

The CHAIRMAN. I know what the Comptroller——

Mr. CONOVER. On the subject of Dimension, the application has been filed and is accepted for filing and we plan on going through an orderly process of reviewing it. We intend to hold public hearings on the subject since it is a matter of great interest to a lot of people. We have also extended the normal comment period beyond its expiration date which I think was last week, and we intend to go through a normal, thorough process, recognizing that we've never had an application like this before.

The CHAIRMAN. What's your opinion of my question about whether the moratorium should be expanded beyond what you have done already?

Mr. CONOVER. I'm concerned that a legislative moratorium would cause some people——

The CHAIRMAN. I wasn't asking about a legislative moratorium. I was talking about a moratorium from the regulator.

Mr. CONOVER. I think if that's possible and it can be extended to institutions other than banks or to the other agencies, that would be beneficial because it would achieve the same purpose that I hope to achieve when we declared the moratorium in the first place, which is to take the heat off that particular issue for a while while at the same time not removing it completely.

Mr. ISAAC. Mr. Chairman, if I might say something else, I had understood you to be asking about a legislative moratorium. If you were asking whether the FDIC would be willing to consider a regulatory moratorium, I didn't understand that to be your question. Is that what your question was?

The CHAIRMAN. I'll ask either of you to answer the question if it were a legislative moratorium, and then I'll go back and ask what about a regulator moratorium?

Mr. ISAAC. We have considered that and we have concluded that we have absolutely no legal authority to impose one and we don't intend to.

The CHAIRMAN. Now we have an answer to both questions, but I want to get back to—let's assume that you are now Comptroller of the Currency. What do you think of that request for 31 applications in 25 States? How does that fit with Dreyfus compared to the Sears and the others, the differentiation you made between what you would and would not do? Is that a different situation in light of McFadden?

Mr. ISAAC. I think it's a different situation. It involves a different set of statutes that have to be considered. No. 1, I'm not the Comptroller, and, No. 2, even the Comptroller is not in a position to make a decision on that application at this stage. He is going to hold hearings and I'm sure he will do an extensive legal analysis, so I would certainly hate to prejudge it.

The CHAIRMAN. Well, then you're lucky my time is up.

Senator Hecht.

Senator HECHT. Thank you very much.

Mr. Isaac, in your statement here, I agree with you when you say there are many opportunities for well-managed banks of all sizes. I agree with you. But as far as the regulation, over the last 20 years I've watched your Agency and I think it's done an excellent job. I think you have everything you need right now. I've watched your different regulators come in. They are all dedicated bank examiners and they've always had one thing that I've admired about them; they're uncanny; they're always right. Whenever we've had problem loans or substandard loans, they were right on target.

So I sort of look at your Agency and it's like the situation where if it works why fix it?

DUAL BANKING SYSTEM

One thing that I would definitely take issue with both of you on, on page 5, "In our opinion, a bank should be permitted to engage either directly or through a subsidiary in the full range of financial services, including securities, real estate, travel agency, insurance, data processing activities." I just can't see how the human element in life will work out.

Let's just say in real estate. For a bank there wouldn't be another real estate man left because he could finance every deal. How could anybody compete with a bank? Let's talk about developments and so on and so forth. In my opinion, this is a step backward because what you would do is more or less bring out the golden rule of banking, "Them that has the gold makes the rule."

In effect, a couple of States are doing something. I don't think that's wrong. Why can't States have their own individual type if they want it? I don't think that here in Washington we have to overreact because one State has a certain type of banking that might be what they want in that State.

Mr. ISAAC. I think you have two different questions there. Let me take the second one first on the State's rights issue.

As you know, a number of States such as South Dakota are adopting laws to liberalize the powers of the State-chartered banks, and I've heard some suggestions made that there ought to be some kind of a Federal override to prevent that from happening. Again, we would be strongly opposed to such a Federal override.

I think the Congress, if it's going to do that, ought to be upfront about it and say we are going to abolish our dual banking system, because to me the one single strength that we should try to preserve in our dual banking system is the right of the States, or the national authorities in the case of a national bank, to determine what powers a bank should have. There may be times when the Federal Government is slow to react, as is the case today quite frankly, to changes in the marketplace, and the States can lead the way by enacting more liberal provisions for their banks. There have been other times, perhaps as was true in the sixties when the States were dragging their feet, then the Comptroller has led the way by allowing national banks new authorities in such areas as leasing and a wide variety of activities. This is the beauty of our dual banking system.

If we're going to try to clamp down on the ability of the States to authorize new activities, then let's be upfront about it and abolish the dual banking system. I would strenuously oppose that, but I think that's the honest way to go about it rather than simply trying to override the authority of the States to enact these measures.

Senator HECHT. Let me just interrupt you. So you think the dual banking system has worked very well?

Mr. ISAAC. I believe the dual banking system has worked extraordinarily well. The major problem with it, that we have to avoid, is using it as a way to forum shop for a softer supervisor. We've taken a lot of steps to clamp down on that, but I don't believe we should ever try to interfere with the ability of States to give banks broader authorities.

If we believe it's getting out of line, we have sufficient authority as insurer of banks to clamp down on unsafe activities.

Senator HECHT. I agree with you.

Mr. ISAAC. I don't believe we need intervention by the Congress on this issue.

The other question you asked relates to the broader powers. For example, if we allowed banks into real estate, insurance activities and the like, wouldn't that present some possibilities for abuse? Perhaps. And, if so, we can regulate that area. We can have antitying statutes, for example, to prevent banks from requiring that people obtain credit from them on homes that they purchase through a bank or the like. There are ways to get at any specific abuses we perceive might arise.

I would point out that these kinds of affiliations exist throughout the country right now outside the banking system. Moreover, there are a number of services that be believe are noncontroversial which banks ought to be permitted right now. Any of the agency services—real estate agency offer services, securities brokerage services, and insurance agency services—where a bank is not acting as a principal should clearly be permitted. These are merely financial services, and they do not involve any safety or soundness concerns. Permitting banks to offer them will greatly benefit the American public, and the only people who are opposed to that are people who want to protect their own turf from competition.

Sears right now offers nationwide real estate brokerage services and securities brokerage services. Its also financing homeowners through it S&L's. It sells insurance. Either we're going to have to strip those businesses out of Sears, or we're going to have to let banks do it. I would prefer, for the most part, to allow banks to engage in similar types of activities. The American public will be the principal beneficiary.

Senator HECHT. I could not disagree with you more.

Let's let the evolution of the marketplace take place. In other words, Sears is doing it, but there's no great shakeup. Other people might do it. But still, why open up the floodgates and just allow it to happen? This has to go over a long period of time.

Mr. ISAAC. To bring financial services to the American public at a reasonable price in a convenient manner.

Mr. CONOVER. If I may add to that, the problem is that these services are being offered outside of the traditional banking system by nondepository competitors and if they become the ones who are providing these innovations in the marketplace, we're going to find ourselves with a gradually stagnating depository system, because banks have an inability to compete to meet their customers' demands for new products and services. Certainly something that we do not want to have, is to have our banking system—our total system of depository institutions—gradually stagnate and become less important in these areas of the country as a whole.

Senator HECHT. But from some of the earnings the past few months from banks all around, they're doing very well. Why not just let banks be banks?

Mr. CONOVER. In a way that's exactly what we're saying. Let banks be banks. We just happen to have a broader definition of banks than has been the definition in the past.

Senator HECHT. That's all I have. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Gorton.

Senator GORTON. Senator Hecht, I wish that I could share your last comments about how well banks are doing. As a result of that, I'd like to move from the general to the specific with both of you.

SEATTLE FIRST BEING PURCHASED BY BANK AMERICA

As each of you is well aware, the capital of the largest bank in the State of Washington has been so severely impaired by losses over the course of the last year as to have resulted over the weekend in a purchase offer from the BankAmerica. Both the Governor and the State Legislature looked on this problem as being one of such gravity that the legislature passed and the Governor signed a bill which would permit that purchase as a matter of State law.

I guess my first and very preliminary question is, in the process of Federal review of that purchase application, does either of your Agencies intend to or does it have a legal role?

Mr. CONOVER. Yes, the Comptroller's Office has a legal role. I believe it is in two areas. As I understand the bill that was passed—and we only got the language a couple days ago—the State banking commissioner will have to make a finding that the bank was—and I may not have the precise words—in danger of closing, failing or becoming insolvent or something like that. We will have to provide information to the banking commission in order for him to make that determination since as the primary supervisor of the bank we are the ones that examine it and have the data concerning it. So that's one role that the Comptroller's Office will play.

The second role is simply the fact that we will provide an advisory letter to the Federal Reserve Board, which we do in all situations in which they are the Agency that has to approve an acquisition by a holding company.

Senator GORTON. Will the FDIC play any role in this process?

Mr. ISAAC. Not to my knowledge.

Senator GORTON. Is it the view of either or both of you that the bank's condition was such that it was in danger of failing or being closed?

Mr. CONOVER. Yes, that is our view.

Senator GORTON. Mr. Isaac?

Mr. ISAAC. It certainly had some sizable losses. To the best of my knowledge, it still would have had a fair margin of capital, but the question is whether the markets would have perceived the capital to be so impaired that the bank would have had liquidity problems. That's a very difficult judgment to make.

Senator GORTON. Under the circumstances as you understand them, do you feel that this solution—the proposed purchase by Bank of America—is the best solution which was reasonably available to Seattle-First?

Mr. CONOVER. I don't think that I should comment about the specific arrangement between the Bank of America and Seattle-First, but if we can turn it into a generic question, the bank announced a very large loss over the weekend, $133 million. That was in contrast to a $9 million loss for the year as a whole in 1982. The question, as Bill indicated, was one of liquidity, one of funding, whether other banks and large depositors would turn away from that bank and in effect cause what could be described as a run over the wires.

If that were true, the bank would be in serious jeopardy. There's no question that it needed additional capital as a result of the losses that it took and also no question that there were not sources within the State of Washington, given the size of that bank and its market position, that could have provided this capital.

So the real dilemma was whether a bill such as the one that was passed should be passed to permit the acquisition by an out-of-State holding company, or whether the risk of failure through a liquidity crisis should be taken on. In any case, if the bank had ultimately failed because of that liquidity crisis, the obvious solution I think is that there would have been an interstate acquisition under the provisions of the Garn-St Germain Act.

Senator GORTON. Mr. Isaac, can you answer that question? Is this the best alternative?

Mr. ISAAC. It's my understanding that it was the only alternative available to the bank at that particular moment. The bank was concerned about putting a deal together within a period of a few short days in anticipation that there might well be liquidity problems if it didn't put a deal together. Under the short timeframe that the bank was operating, it's my understanding this is the only proposition that they were able to come up with.

Had the bank had a little more time, I suspect that they might have been able to come up with other possibilities.

Senator GORTON. During the course of the next 60 days of review by the Department of Justice and the Federal Reserve Board, can either of you see any other practical alternatives which might intervene in that period of time?

Mr. CONOVER. Well, the offer that has been accepted is subject to three important conditions—at least one of which has already been met through the passage of the bill in the Washington State Legislature. It is subject to Federal regulatory approval and it is also subject to approval by the shareholders. It's conceivable that the shareholders could reject the offer or that another offer that they would prefer to consider might be forthcoming.

Senator GORTON. That is a possibility. In other words, at this point other banks or other organizations or individuals presumably could put together an offer which might be found more attractive by the shareholders?

Mr. ISAAC. Yes, that could very well happen. It's my understanding that the bank's board has accepted the offer, it's my understanding, but the shareholders aren't committed to it. If there's a better offer they would like to consider, I believe they would have that opportunity.

I might also state that the FDIC was not promoting this change in State law. Our position, officially and unofficially, was one of complete neutrality. We felt we had good solutions whether or not Washington changed that law.

Senator GORTON. What were those good solutions?

Mr. ISAAC. I'd rather not go into them at this stage if I could avoid it, but there were plenty of options available for dealing with this situation had the need arisen.

Senator GORTON. And in case of insolvency would the FDIC have in some respect or another taken over operation of the bank in protecting its own insurance investment?

Mr. ISAAC. We had a number of options that I'd just as soon not go into at this stage.

Senator GORTON. I'd like now to go perhaps to theory a little bit more. Is it your view in our review of these banking laws that it should be as a matter of general policy appropriate or inappropriate to encourage or to allow or to prohibit the merger of a large bank organization in one State, the largest organization in such a State, by the largest banking organization in another or a neighboring State?

ANTITRUST LAWS INADEQUATE

Mr. ISAAC. In our testimony we tackle that subject straight up by saying that, particularly if the geographic restraints are liberalized to permit nationwide or interstate banking, we believe the current antitrust laws are inadequate and need to be addressed.

The problem is that the laws currently require us to focus on rather narrow geographic and product markets. We have very rigid rules whenever two $20 million banks in a town of 10,000 people want to merge. At the same time, Prudential is permitted to acquire Bache, American Express buys Shearson, Bank of America buys Seattle First and the like. The current law does not consider the general structure of the industry and overall concentration levels in the financial services industry.

Senator GORTON. But those are matters that should be of concern to us?

Mr. ISAAC. I believe they very definitely should be of concern.

Senator GORTON. Mr. Chairman, my time has elapsed. Could I get Mr. Conover to answer the same question?

The CHAIRMAN. Certainly.

Mr. CONOVER. In my view I think it's appropriate to permit interstate acquisitions of both healthy and failing institutions. At the moment, I think it's particularly important that they be permitted for failing institutions.

Senator GORTON. Without regard to the size of the acquired or the acquiring institution?

Mr. CONOVER. I think in that case the normal antitrust review ought to take place and if a conclusion is reached that it violates the antitrust laws, then it ought not to be permitted.

Senator GORTON. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Sasser.

Senator SASSER. Thank you, Mr. Chairman.

Chairman Isaac, since the passage of the Garn-St Germain bill last year you have developed a great deal of experience, probably more than you would have wished I guess, in carrying out the title which provides for extraordinary acquisitions in the event of bank failures.

As pointed out in the testimony, in 1982 alone 42 banks failed. So far this year, 15 banks have failed. Senator Gorton was expressing some concern I judge about what's happening in the State of Washington. And unless we can arrange for some more capital we're going to have another small bank fail in my State during the next 48 hours.

Now the acquisition process allows for interstate acquisition under certain conditions, when size and other criteria are met. I note the FDIC is officially neutral on the subject of removing the geographic restraints and I think you just perhaps reaffirmed that neutrality, if I understood the line of questioning of Senator Gorton, but I note that there is concern about possible adverse effects of the undue concentration of economic power if some of these restraints are removed.

Now if the bank failure rate remains as high in 1983 as it was in 1982, and I suspect it's going to be higher, we're going to continue to see major acquisitions for the balance of this year.

Do you have any specific recommendations that you would make for dealing with this undue concentration of power? I understand you're holding public hearings on related issues and I'm interested in the solutions that might be proposed.

Mr. **ISAAC**. We've got two different situations. In a failing bank situation you try to come up with the best alternative you can come up with—the least anticompetitive alternative, the least expensive, and the least disruptive—but in the end you've got to get it done, so on occasion you may stretch the antitrust laws here and there in a failing bank situation. But generally speaking, with respect to nonemergency acquisitions, it seems to us that the Federal Reserve back in the sixties had a pretty good notion. It applied the potential competition doctrine which, stated in the simplest terms, provided that the largest organizations in a given State were not to be permitted to enter significant new markets by acquiring the largest institutions within those markets. It's not a bad rule. The courts, unfortunately, have emasculated it. What we have left is an antitrust law that comes down hard on combinations of very small banks in small towns and doesn't give us any tools to deal with larger acquisitions by larger firms.

That is becoming of increasing concern as we move into a more deregulated environment. The geographic restraints and some of the other restraints have served as a proxy for antitrust enforcement. They have mandated a fairly diverse, diffuse banking system. But without these restrictions and without an adequate antitrust law, we are concerned about the possibility of undue concentration in the financial system. We would find that philosophically objectionable and also objectionable from an insurance point of view because concretrating financial resources in fewer and fewer hands will pose greater and greater risks.

Senator **SASSER**. I can well imagine. The task force group on regulation of financial services is considering the feasibility and advisability of merging the functions of the regulators into one supervisory body or at least somewhat short of that reorganize certain regulatory functions of the FDIC and the Comptroller and also the Federal Reserve.

Under the current system there is a division between Federal regulation of State-chartered banks through the FDIC and Federal regulation of federally-chartered banks through the Comptroller's Office. This regulatory separation of powers may have created its share of problems, but I think it's also helped to sustain the dual banking system which I understand, Mr. Chairman Isaac, you strongly supported in your answers this morning before I got to the hearing.

If major elements of the regulatory framework are combined, do you foresee a blurring of the line between federally-chartered banks and State-chartered banks? In other words, could a consolidation at the Federal level lead to some loss of authority on the part of State supervisors? Is that good or not?

FDIC PROPOSAL STRENGTHENS DUAL BANKING

Mr. Isaac. Under the plan the FDIC has proposed, the dual banking system will be greatly strengthened. Right now we really don't have a dual banking system in the true sense of the word in that State banks have imposed on them a tremendous amount of unnecessary, duplicative FDIC or Federal Reserve oversight. Every aspect of the bank's operations are governed by the FDIC or the Fed, in addition to the State.

Under the proposal we have put forward, the regulation of federally chartered banks and thrifts would be consolidated into a new regulatory agency headed by an independent agency. State authorities would have responsibility for State-chartered institutions. The FDIC would be a separate body. It would play the same role irrespective of a bank's charter. It could be called an S&L, a national bank or a State bank and the FDIC's role would be the same. It would have a primary supervisory which would be responsible for handling all regulatory matters affecting the institution. The FDIC would examine the institution only if it were a problem or a near-problem institution. We would only examine the healthy ones on a very limited sampling basis.

Basically, we will focus our resources and our attention on the problem institutions and the near-problem institutions. The States will have far more authority with respect to supervising their institutions than they have today.

Senator Sasser. I indicated that in 1982 42 banks failed and 15 have failed so far this year. Mr. Isaac, do you anticipate we will have more bank failures in 1983 or less?

Mr. Isaac. We have predicted that we will have as many or more.

Senator Sasser. As many or more than, but not less than?

Mr. Isaac. That has been our prediction. I will be pleasantly surprised if there are fewer.

Senator Sasser. I think we're going to have significantly more than in 1982.

Mr. Isaac. Pardon?

Senator Sasser. We're going to have significantly more bank failures in 1983 than 1982, in your judgment?

Mr. Isaac. 1983 will involve at least as many bank failures, we believe, as we had last year.

Senator Sasser. Well, I expressed yesterday to Chairman Volcker my concern about the condition of many banks across the country and, of course, we are all well aware that the banking system relies very much on confidence and faith and I don't want to be spreading hysteria, but I do want to say I am very concerned about what I read and hear in the southern part of the United States anyway.

Thank you, Mr. Chairman. My time is up. Maybe Mr. Isaac wants to respond to that.

Mr. Isaac. If I could respond to that last point. We don't see anything alarming happening in banking. We wish we were not involved in handling this many bank failures, but there are very few failures that we haven't fully anticipated. The failure rate is running remarkably close to what we have predicted in our internal discussions. There haven't been any real surprises and there's nothing to be alarmed about. It certainly causes trauma in individual situations, as you know as well as anybody, when a bank fails, but we have been handling them in an efficient, nondisruptive manner.

Senator Sasser. Thank you.

The Chairman. If I could just emphasize that point before I turn to Senator Lautenberg, I certainly don't want to minimize the individual failures or the trauma that that does create, but as chairman of the committee, obviously I follow this situation very, very carefully on a daily basis to keep aware of what is going on, and although there are an unusually large number of bank failures in the last 2 or 3 years and S&L failures as well, but particularly in the banking industry, you will find almost without exception that the failures are not necessarily due to the economy or to deregulation either in 1980 or 1982. They are primarily due to fraud, dishonesty, mismanagement that have nothing to do with the general conditions of the economy. I only say that to reassure people that the general banking system is not in trouble beyond the fact that the FDIC fund is larger after these failures than it was before. The fund has continued to increase but with Penn Square and most of the banks that you look at—and I think you will see in some of the situations it will be followed up with criminal charges and so on. I just wanted to make that distinction, not to minimize the problem nor condone fraud, waste and abuse and mismanagement, but at least we indicate with 15,000 banks in this country the vast majority of them are managed by people who are honest and are doing well and will survive and it behooves us to look at how we can better control and regulate those who would be dishonest and who would make very bad policy judgments in their loan policy.

Senator Sasser. I might just respond to the chairman and say that I'm reassured by his statement, but I would also say that there are a number of banks in my State, particularly those that specialize in loans to farmers and agriculture-related endeavors, that are well-managed, that have honest, upright managers, but judging from what the bank officers are telling me are in rather shaky condition brought about principally by the problems with agriculture and the economy. That's one of the things that I'm concerned about and I think many of us from agricultural States have the same concern judging from my conversations with other colleagues.

The CHAIRMAN. Senator Lautenberg.

Senator LAUTENBERG. Thank you, Mr. Chairman.

I don't want to place either of the witnesses in the hot seat, but——

The CHAIRMAN. Why not? They're used to it.

Senator LAUTENBERG. Well, OK. Do you generally agree with Chairman Garn's statement about the reason for failure? I noticed Mr. Conover was shaking his head. That it's primarily fraud and dishonest practice?

REASONS FOR FAILURE

Mr. CONOVER. I think if you look over the last year to the 42 failures in 1982 that very often the reasons for failure were precisely for the reasons that the chairman cited. I think included in those numbers were also some mutual savings banks.

Senator LAUTENBERG. We're not describing mismanagement as fraud or deception. One can make an honest attempt and still mismanage an institution.

Mr. CONOVER. That's true, but there were instances of fraud and other illegal activity involved in some of those bank failures.

Senator LAUTENBERG. Some or most?

Mr. CONOVER. I don't think I can say off the top of my head.

Senator LAUTENBERG. Mr. Isaac?

Mr. ISAAC. I would say that most of them involved some element of either illegality or inside abuse.

Senator LAUTENBERG. How about extension of credit to foreign nations by major banks where the creditworthiness of the borrower doesn't meet the accepted standards? Is that the same kind of thing?

Mr. CONOVER. That has not contributed to any bank failure in 1982.

Senator LAUTENBERG. Has it created any problems that you're concerned about?

Mr. CONOVER. Of course, it has. We testified before that the international lending situation that we're facing today is a serious problem, that our banks are in fact overexposed to some nations who are having difficulty servicing their debts or getting new capital in the private markets.

Senator LAUTENBERG. Is that mismanagement?

Mr. CONOVER. To a degree. It is in the sense if you say they should have been able to anticipate some of these difficulties or to ask whether it would have been more prudent to have kept exposures down and focused on principles of diversification.

Mr. ISAAC. To reinforce what the chairman was just talking about, I thought I might describe a telephone conservation I had the other day. I had been hearing that the FDIC had been overly aggressive in certain State that has had some serious economic problems. So I called the Commissioner and I said, "I've been hearing that our folks may be overly aggressive in supervising the banks and picking on some people a little harshly. What do you think?" His response was that every one of the problem banks in that State was in trouble due to the fact that it was guilty of gross mismanagement—that the problems in the banking system in that State were not caused by the economy. The only fault he could find with the FDIC—and he said he would blame himself as well—is that we didn't come down on the problems sooner and harder.

Senator LAUTENBERG. That suggests, Mr. Isaac, that perhaps further deregulation isn't the best way to go; part of the regulatory process is a review of prudence and things of that nature.

Mr. ISAAC. I couldn't disagree more. We need more deregulation. As a result of over 50 years of excessive regulation, we have a small but significant number of institutions that simply do not have the management, do not have the ability to compete in the real world and often——

Senator LAUTENBERG. In other words, let the market conditions take care of them?

Mr. ISAAC. Yes.

Senator LAUTENBERG. How about the individual borrower who may not have done badly in this cumbersome antiquated system? Yet in the last couple years was unable to borrow and, in many cases, unable to sustain a small business?

Mr. ISAAC. Well the borrowers who have not been able to reborrow for the most part should not have been borrowing in the first place. Recognizing there are some disruptions and hardships in individual cases, for the most part, a good borrower is normally taken care of elsewhere quite readily. The ones that can't get refinanced elsewhere are the ones that shouldn't have been in the bank in the first place, at least not to the extent they were.

Senator LAUTENBERG. The loss experience was not terrible in those years for the banks. When were they making these kinds of loans?

Mr. ISAAC. The loss experience?

Senator LAUTENBERG. Yes. Banking generally in the years before the last couple——

Mr. ISAAC. Banks for the first 20 or 30 years after the depression were extremely conservative and the loss experience was very low, but that has not been the experience in the last 10 years or so. There seems to be more and more risk in the system and that's why we have proposed a number of reforms, including improvement of our regulatory system.

We're not marketplace disciples to the extent we think you ought to abandon the regulatory system. Indeed, we have put forward some proposals to greatly strengthen the supervisory system—to streamline it and make it more efficient and more effective. But at the same time, we are also looking for ways to impose a great degree of market discipline.

Senator LAUTENBERG. Banks serve, in my view, a somewhat different function than the traditional business. We've seen this in States where a bank failure, whether it's for mismanagement or corrupt practice, wreaks havoc. I know that Senator Gorton is very concerned about what's taking place in his State. Whatever the aftermath, there isn't a high degree of comfort in having someone from outside buy that bank.

But you seem pretty satisfied about your projections for bank failures. I don't mean to imply that you were pleased at the number of bank failures; rather, that you thought that your projections were reasonable. But the fact is that looking at this year's contemplated failures versus last year's—do you know what you might expect this year? There obviously must be some soft spots that you're very well aware of at this point. What might be expected in terms of size of total failure, total exposure? Do you have any idea compared to last year?

Mr. ISAAC. I have an idea, but I'd rather not go into it at this point. One thing I should make clear is that while a large bank failure may be more notable on a national level, the failure of a small bank can be just as disruptive on a local level. So when you look at it in terms of the customers of the bank, a bank failure is a bank failure, irrespective of the size.

Senator LAUTENBERG. I guess it's fairly obvious that I'm particularly concerned about leaving a small borrower or a small business firm out of the traditional bank relationship. There's opportunity for the banks to make more money in other kinds of products, and I see that as a real problem.

You talk about high risk and normal risk in the insurance system. How do you define very high, and high, and who do you expect who would be depositing in a very high risk bank?

Mr. ISAAC. If I could just make one comment on your statement about smaller businesses and consumers having access to credit I would point out that these people have far more access to credit today than they had 20 years ago and the reason why they have is because of this process of an expanding, less regulated financial system. It's those very people that deregulation is benefiting. The very largest corporations have always had access to credit even in a tightly regulated environment, but as we have evolved toward a less-regulated financial system, credit has been made available to more and more people and more and more small businesses.

So I think that's really one of the positive elements of deregulation, not something to be feared.

THREE RISK CATEGORIES

With respect to the FDIC proposal that we have a risk-related insurance system, we have proposed that banks be divided into three categories: Normal risk, high risk, and very high risk. We would envision that we would try to put 80 or 90 percent of the banks into the normal risk category. We don't believe that risk-related premiums will be a cure-all or a panacea. We don't believe anybody can actuarially price insurance premiums. All we're trying to do is identify the outliers, and charge them more for their deposit insurance.

We have two tests for getting a bank into the highest risk category. You can get in there by either having a very low capital ratio or by having a combination of a high degree of classified assets and a high degree of interest rate risk in your portfolio. If a bank is in the highest risk category, it would not get an assessment rebate. In effect, it would be paying in a normal year about twice what a normal risk bank would be paying.

The middle category of bank, the high risk bank, is one that flunks either the test on asset classifications or the interest rate test. The bank in the middle category would get half of the assessment rebate. The vast majority of banks, 80 to 90 percent of them, would fall in the normal risk category and their premiums wouldn't be changed from today.

In addition in this proposal, we will request authority to charge the high risk and very high risk banks administrative fees to cover the cost of the increased supervision they require.

Senator LAUTENBERG. I'm out of time. Thank you very much.

The CHAIRMAN. Thank you very much. Before I turn to Senator Heinz, let me just make sure that Senator Lautenberg understands my comment when you asked them to respond to it if they agreed. I didn't want you to think I only said that they were due to fraud and dishonesty. I put in the category of fraud and dishonesty and mismanagement. So I wasn't sure whether from the nature of your question you thought I had attributed them all to fraud and dishonesty.

Senator LAUTENBERG. No, but you and I—both coming from the business world—know that business failures classically are mismanagement. That's not exceptional behavior, and I just wanted it to be clarified.

The CHAIRMAN. No, you're correct, it is not; but that's why I wanted to distinguish the mismanagement which goes on and has gone on in any type of environment from the particular problems of today's economy or from the deregulation of 1980 or 1982. That was the distinction I was making, not that mismanagement was something new and different that had never occurred before.

Senator Heinz.

Senator HEINZ. Chairman Isaac, I was interested to read in today's Wall Street Journal an article regarding the First Pennsylvania Bank, a very valued institution in my State Mr. Chairman, I'd ask that the article appear at the conclusion of our discussion in the record.

FDIC SUBSIDIZED FIRST PENNSYLVANIA BANK

The CHAIRMAN. I'd be happy to do so.

Senator HEINZ. The article stated that the bank is paying off $150 million of their financial assistance package that was put together in 1980 and I think it's a good indication that the FDIC assistance program is working and I commend the FDIC on its wisdom and far-sightedness in putting that package together.

Do you believe that the First Pennsylvania is on the road to recovery and, in your judgment, are you and First Pennsylvania doing everything to assist that recovery?

Mr. ISAAC. I don't know whether it's on the road to recovery or not, but we and I hope the bank are making every effort to insure that it is.

Senator HEINZ. What rate of interest are you and the private banks charging on their loans?

Mr. ISAAC. I don't know what the private banks are charging. The FDIC is charging 125 percent of its investment portfolio yield.

Senator HEINZ. All right. My understanding is that for the first year the loan to First Pennsylvania was interest free and the reason that you're charging the higher rate now is that this now permits you to recoup what you didn't charge them during the first year. Is that correct?

Mr. ISAAC. The theory is that it's a 5-year loan and the first year was interest free. What we were trying to do is recoup the same amount of money from First Pennsylvania in interest that we would have earned on our own portfolio of investment securities. So by charging them 125 percent of our portfolio yield for the next 4 years we would over the 5-year period be achieving 100 percent of our portfolio yield. Of course that is thwarted to a degree by First Pennsylvania's decision to pay off part of the debt early because we are not collecting interest on that any more at the 125-percent rate. So to that extent they have gotten a benefit that we didn't intend.

Senator HEINZ. First Pennsylvania is in a position to pay off $150 million and to possibly make further payment. It's my understanding that one of the reasons the First Pennsylvania had to pay off the $150 million is that paying you a spread of 25 percent again over your average portfolio yield was a signal to other investors that they should demand a premium of an equivalent nature from the bank for investments in long term, medium term, or equity instruments. It seems to me that the FDIC should want to have these loans repaid just as quickly as possible. I think you would agree with that, would you not?

Mr. ISAAC. I would be happy to have them repaid. I was only pointing out that when they repay them they take away our ability to make up for that year's worth of free interest. I'm willing to see that happen because I think if the FDIC weren't involved in there at all it would be better, but I was only pointing out that they are getting a substantial benefit when they do repay early without penalty.

Senator HEINZ. Yes, and I guess isn't that also an argument for trying to have a rate that is more even?

Senator HEINZ. What I'm saying is that if you had it to do all over again, would it have been better to have had a more even and lower interest rate?

Mr. ISAAC. What we probably should have done if we had it to do all over again was to charge interest that first year and then we wouldn't be affected by these early prepayments.

Senator HEINZ. I assume the reason there was no interest the first year is that the people thought you couldn't get blood out of a stone.

Mr. ISAAC. The reason why there was no interest the first year was that we were trying to assist the bank in its recovery and have it show a stronger earnings performance or at least a less negative earnings performance than it otherwise would have had. It was hoped by the bank that by this time it would be earning a profit and it would be able to support the payment of the higher interest rate in the later years through earnings.

Unfortunately, the bank has not turned around on earnings nearly as fast as it had hoped.

Senator HEINZ. Mr. Isaac you are responsible for safety and soundness of federally insured banks. That is what all these hearings that Chairman Garn has scheduled are all about. It seems to me that I can make an argument that the way to get an institution like the First Pennsy on the road to recovery is to be judicious in the kind of interest rate you charge. We will have a sounder institution that is able to stand on its own two feet faster if the FDIC renegotiate the terms of the original loan.

The sooner the First Pennsy is able to go to the market to borrow, as opposed to the FDIC for specific assistance, the sooner that will mean to everybody that it's on its own two feet?

Mr. ISAAC. What First Pennsylvania needs to do is turn its earnings situation around and raise some capital. It has already received a substantial subsidy from the FDIC and I don't see any basis for increasing that subsidy.

Senator HEINZ. When you assisted First Pennsylvania it was to prevent a worse situation from happening. Clearly the First Pennsy was faced with a very difficult, bad, even disastrous situation, had the FDIC not stepped in at all. You would agree with that I think. It was facing a very difficult, perhaps disastrous situation.

Mr. ISAAC. Very difficult and disastrous from the point of view of the bank, yes.

Senator HEINZ. Yes, and from the standpoint of the depositors.

Mr. ISAAC. No, I don't think the depositors would have had any reason to be concerned if we had not stepped in. We could have taken care of them through other means.

Senator HEINZ. Presumably you stepped in then for reasons of safety and soundness of the banking system.

Mr. ISAAC. I think the decision was made to step in because it was felt that handling First Pennsylvania by way of merger transaction at that time could have been disruptive in the national financial markets. I don't know that I agree with that view, but there's a significant difference between then and today in that at that time we didn't have the Garn-St Germain authority for an interstate transaction and our options were considerably more limited.

Senator HEINZ. What I hear you saying is that you weren't there when the decision was made.

Mr. ISAAC. Oh, I was there.

Senator HEINZ. You were?

Mr. ISAAC. Yes.

Senator HEINZ. Well, then, I guess you were there and you're saying you might make a different decision today but when you made it it was the right decision in view of the the overall safety and soundness of the system. Is that right or am I putting words in your mouth? I don't understand why you resist the words I'm trying to put in your mouth. [Laughter.]

Is there some hidden meaning that you know about that I don't know?

Mr. ISAAC. Well, we did what we did and it's behind us. I'm not of a mood to reopen the subject of whether we should give First Pennsylvania even more subsidy than we have already given them. I think they've gotten more than their fair share of subsidy out of the FDIC fund.

Senator HEINZ. I gather you therefore are a little unwilling to pursue measures that might speed up improvements to the safety and soundness of the banking system. You feel that the banking system today is in great shape. That's why you have endorsed the

Heinz-Proxmire II regulators' bill to the IMF because things are in such good shape, right; and indeed why you would like to go further than Heinz-Proxmire in some respects?

Mr. ISAAC. How is that?

Senator HEINZ. Well, we're getting ahead to the insurance study.

Mr. ISAAC. The banking system is in comparatively good shape. First Pennsylvania has to do some things to get back on the road to recovery. It has not had as fast a turnaround in earnings as the bank management thought it would have. Its capital is still too weak. It needs to resolve those problems. Giving the bank a few hundred thousand dollars or even a couple of million dollars out of the FDIC fund is not going to make or break that bank. What that bank needs to do is make some fundamental changes.

Senator HEINZ. Mr. Isaac, my time is expired, but with the forebearance of the committee let me make something as clear as I can so that there's no misunderstanding.

If First Pennsylvania could prove to you that you could be taken out of the loans, through flexible renegotiation are you saying that you would be unwilling to exercise such flexibility even if such flexibility could lead to capital improvements by allowing First Pennsylvania to go to the markets and raise capital. By raising capital the bank would take the FDIC out quickly and make First Pennsylvania healthier.

Mr. ISAAC. We have made it clear to the bank, and I would reiterate it to you, that we would be willing to consider any readjustment program which brings about a long-term, overall solution to the bank's situation.

We are not, however, willing to give the bank a further subsidy to permit it to continue business as usual. If it's part of a comprehensive plan to resolve the bank's problems and does not further subsidize the bank's stockholders we will consider any reasonable solution.

Senator HEINZ. That's my point. I think we now understand each other.

Thank you, Mr. Chairman.

[Wall Street Journal article referred to by Senator Heinz follows:]

[From the Wall Street Journal, Apr. 27, 1983]

SOME DEBT PAID EARLY BY FIRST PENNSYLVANIA

BANK RETURNS $150 MILLION OF $500 MILLION IN AID THAT ISN'T DUE UNITL 1985

(By Frank Allen)

PHILADELPHIA.—First Pennsylvania Bank, in a bid to demonstrate improving financial health, paid $150 million of the $500 million in rescue loans it received from the Federal Deposit Insurance Corp. and a group of banks.

The loans, made in 1980 to help First Pennsylvania avoid collapse, aren't due until May 1985.

The bank's holding company, First Pennsylvania Corp., also asked 35 commercial banks that have extended $1 billion of lines of credit under the rescue plan to reduce those credit lines to $700 million over the next 12 month.

The bank is still operating in the red, although its 1983 first-quarter deficit of $5.2 million, reported yesterday was narrower than losses for the 1982 fourth quarter and the year earlier quarter.

IMPROVED LIQUIDITY

Meanwhile, the banks liquidity has improved greatly. Since Dec. 14, First Pennsylvania has taken in about $250 million of new deposits for government-insured money-market accounts.

Monday afternoon, the bank repaid $97.5 million to the FDIC and $52.5 million to the group of banks participating in the rescue plan. The repayment will save the bank about $4.3 million in interest and amortization costs this year.

George A. Butler, chairman and president of the bank and the holding company, said the partial repayment shows that First Pennsylvania is making progress, "but much still needs to be done." The bank still has "a high level of nonperforming loans" and a "large investment portfolio with low yields," he said. The bank also needs to attract more capital to strengthen its balance sheet, he said.

APPLAUSE AT MEETING

When Mr. Butler announced the partial repayment yesterday at the annual meeting here, the audience of about 700 broke into applause.

He also announced that the holding company will prepay in the next few days $10 million of a separate loan, due in August to a group of five banks. He characterized the prepayment as "additional evidence of our continuing progress."

In the spring of 1980, First Pennsylvania faced a liquidity crisis because of weak loan and investment portfolios and other problems. Large deposits from money markets weren't being rolled over when they matured, many depositors withdrew large amounts, and the bank was borrowing heavily from the Federal Reserve System on an overnight basis.

The rescue loans, however, also have been a burden. Interest on the debt has been as high as $18,3 percent. In the 1982 fourth quarter, the bank paid $18.9 million interest on the loans. In the first quarter of 1983 interest on the loans was 13.6 percent, and it has been reduced slightly since then.

To repay part of the rescue loans, First Pennsylvania had to reduce its asset base sharply. As of March 31, the bank holding company had assets of $5.2 billion, compared with $9.1 billion at the beginning of 1979.

In addition, many former customers had to be persuaded to return and new consumer deposits had to be attracted. Consumer deposits have increased 40 percent to $1.3 billion from $854 million since December 1981.

About $80 million of the increase came in the first 11 months of 1982, but then First Pennsylvania started offering its money-market account, and that service has attracted $250 million, Mr. Butler said, giving the bank the cash to repay part of its debt.

First Pennsylvania's 1983 first quarter loss of $5.2 million compared with a loss of $5.9 million a year earlier and followed a $6.8 million deficit in 1982's fourth quarter. The bank said the latest results include a charge of $[illegible] million for writing off a discount related to the $150 million debt repayment.

Without the one-time charge, Mr. Butler said, the bank's first-quarter loss would have been $1.3 million. He attributed the improved operating results to an increase of $2.5 million in net interest revenue, reflecting [illegible] assets and lower costs of carrying long-term, fixed-rate assets.

The **Chairman**. Thank you, Senator Heinz.

Senator Specter is not a member of the committee but wished to ask the gentlemen questions about the same subject but is chairing another hearing. As a courtesy to him, I would like to submit some written questions from Senator Specter for your response in writing.

[The following questions and their responses are submitted for the record:]

United States Senate
WASHINGTON, D.C. 20510

April 28, 1983

Honorable William M. Isaac
Chairman
Federal Deposit Insurance Corporation
550 Seventeenth Street, N.W.
Washington, D.C. 20429

Dear Mr. Isaac:

I had intended to pose several questions at your hearing before the Senate Banking Committee, but was required to chair another hearing at the same time.

I understand that the First Pennsylvania Corporation has been provided $325 million in Section 13(c) loans by the FDIC and an additional $175 million in loans by a consortium of banks. I have been informed that there was no interest charged for the first year of the loans, but that the current rate is 13%.

The First Pennsylvania Corporation has apparently made considerable progress in straightening out its financial situation, as witnessed by the $150 million in payments on these loans announced this week. It has been reported to me, however, that the bank is under-capitalized and must show a profit in the third and fourth quarters this year in order to obtain needed funding. Critical to the bank's ability to show a profit is a reduction in the 13% rate which is now being charged by the FDIC.

Accordingly, I pose the following questions:

(1) What steps will the FDIC take to lower the 13% rate in view of the needs of First Pennsylvania Corporation and the fact that the consortium of banks have reduced its rates?

(2) To what extent is the FDIC taking into account the enormous losses that would result if the bank fails to meet its obligations or capital requirements due to the inflexibility of the FDIC?

I look forward to your early response to these questions.

Sincerely,

Arlen Specter

AS:bl:sd

FDIC
FEDERAL DEPOSIT INSURANCE CORPORATION, Washington, D.C. 20429
OFFICE OF DIRECTOR - DIVISION OF BANK SUPERVISION

1983 MAY 19 PM 4: 33

May 18, 1983

Honorable Arlen Specter
United States Senate
Washington, D.C. 20510

Dear Senator Specter:

I have been asked to reply to your letter of April 28, 1983, to Chairman Isaac. In your letter, you asked to be advised of the steps the Federal Deposit Insurance Corporation will take to lower the 13% rate now being charged on the FDIC's portion of First Pennsylvania Bank's debt, taking into account the losses that would result if the bank fails to meet its obligations.

The rate charged on the debt was set in the assistance agreement at 125% of the FDIC's investment portfolio yield and was designed to compensate the FDIC for not having charged any interest in the first year of the assistance transaction. This yield is based on market interest rates; therefore, the resultant rate charged First Pennsylvania Bank, is a function of market rates, over which the FDIC has no control. The rate charged on the debt will fall, or rise, with the market. The participating banks, on the other hand, were compensated on their loan from origination at a market rate of interest. The rate reduction on the participating banks' portion of the debt has been a function of a decline in market rates not a concession by the participating banks.

The FDIC obviously could provide additional assistance to First Pennsylvania Bank through interest rate concessions. Also obvious is that additional assistance of the type being suggested translates into a direct windfall to the bank's earnings and, therefore, to its stockholders, who are no more entitled to a windfall from FDIC than the stockholders of any other insured bank.

We entered into the initial assistance agreement at a time when the bank was considered in need of a measure of longer-term stable funding and a show of strength to mitigate a perception of weakness and to stem the related funding outflow. That effort succeeded, sparing the bank from the judgment of the marketplace and giving the bank's management the time to prove its assertions concerning the bank's longer-term viability.

We considered giving First Pennsylvania Bank the opportunity for survival to be a proper undertaking. But helping to provide the means of survival, through an earnings contribution, is not the same thing and is not similarly regarded. The problem, we have attempted to convey to First Pennsylvania's management, is the bank's, not the FDIC's. The solution, to the extent it exists, moreover, depends upon proper management and upon accessing private capital markets, either through a public offering or a private placement. If the bank indeed is not viable, cannot meet its obligations, and experiences the losses to which you alluded, then we stand ready to meet our obligation to the bank's depositors.

If I can provide any further clarification of the FDIC's position in the matter please let me know.

Sincerely,

James L Sexton

James L. Sexton
Director

The CHAIRMAN. Senator Riegle.

Senator RIEGLE. Mr. Chairman, I share the interest that Senator Heinz has expressed and Senator Specter is also expressing and I assume we would face a very substantial cost if this First Pennsylvania were not to succeed. I assume that would be the case; would it not?

Mr. ISAAC. I don't know whether we would or not. I don't think it would be excessive.

Senator RIEGLE. What would you consider excessive?

Mr. ISAAC. Under the new options we have available to us that situation could be resolved without a very large expenditure.

Senator RIEGLE. In what kind of range would you say?

Mr. ISAAC. I couldn't give you a precise number at this point and I don't think this would be the best forum to do it in anyway.

Senator RIEGLE. The reason I asked is because, in the Budget Committee we are struggling mightily to try to bring down a $200 billion-plus deficit. For that reason I would view any expenditure that could be avoided as excessive. So I would hope that if we could find a way to try to work these situations through we would do so.

Mr. ISAAC. I think we have demonstrated over the past couple of years a fair amount of skill in resolving difficult situations with minimal outlay's in a manner which has served the public well.

HIGH BIDDER ABSORBS FAILING INSTITUTION

Senator RIEGLE. When an institution in difficulty, and it may be necessary to find somebody else to come in and take over the situation, should the normal practice be to look actively for the high bidder; and find somebody who could come in and absorb the institution?

Mr. ISAAC. We always try to expose a failing institution to the maximum number of bidders, and we always select the high bidder.

Senator RIEGLE. And then the approach is normally to open it up to the widest number of interested parties?

Mr. ISAAC. We try to go out as far as we can within the law.

Senator RIEGLE. And if someone comes forward and wants to be considered and they meet the criteria, they are included in the competition just like anybody else?

Mr. ISAAC. Yes. We try to make the list as big as possible and still have it within reasonable bounds. We don't want 300 people on the list.

Senator RIEGLE. Right. I think it is important that it be as broad as possible, that it be formed openly, that we go for the highest bids, et cetera.

That is all for me right now.

The CHAIRMAN. Thank you. Gentlemen, as always in these sessions, there are many, many more questions that each of us would like to ask but time does not permit us. We have another panel to appear on the subject this morning. I do have additional questions that I would like to submit to you for your response in writing and I assume other Senators will as well. We thank you very much for your willingness to be here this morning and we will excuse you at this time.

And we'd like to call before the committee the Honorable Richard T. Pratt, Chairman of the Federal Home Loan Bank Board; and the Honorable Edgar F. Callahan, Chairman of the National Credit Union Administration.

Chairman Pratt, we are happy to have you with us again. The last time you were here I thought that was your last appearance and I'm happy that we have one more opportunity once again to express my disappointment that you find it necessary to leave Government service. I commend you for the fine job that you have done in your 2 years at the Federal Home Loan Bank Board and thank you personally for your cooperation and communication with me over the last 2 years in working through some very difficult issues for the savings and loan industry of this country. You will be missed by the committee and certainly by the administration. We appreciate your service. We'd like to begin with you.

STATEMENT OF RICHARD T. PRATT, CHAIRMAN, FEDERAL HOME LOAN BANK BOARD

Mr. PRATT. Thank you, Senator. I have written testimony which I would like to put into the record. I will try and be brief with some opening oral comments.

[Complete statement follows:]

TESTIMONY OF
RICHARD T. PRATT, CHAIRMAN
OF THE
FEDERAL HOME LOAN BANK BOARD

Mr. Chairman and members of this distinguished Committee, I appreciate the opportunity to discuss with you the domestic financial services industry. The outlook for thrifts and all regulated financial depositories has improved substantially during the last year, due largely to the recent decline in interest rates and the Garn-St Germain Depository Institutions Act ("the Act"). This Act, which was absolutely essential to thrifts' survival in the deregulated marketplace, substantially increased their operating flexibility and recognized the futility of mandating asset specialization while these institutions were competing with all other intermediaries on savings accounts.

CURRENT ISSUES IN FINANCIAL DEREGULATION

The Bank Board believes that even though a great amount of deregulation and change has occurred, we are perhaps only halfway through the process. Previous changes inevitably dictate further reform of the regulatory framework. I am particularly concerned that the regulated financial system is now in disequilibrium; we must address the system's structure if we are to restore and maintain stability. Because we have moved the regulated depositories into the 20th century, it is now imperative to modernize the supervisory system as well.

Historically, the statutory and regulatory framework attempted to minimize the exposure of the federal insurance funds by imposing rigid controls on operations to protect the safety and soundness of insured depositories. Today, unforeseen economic conditions, coupled with partial legal and de facto deregulation of product and price controls on financial services, have occurred without corresponding reform of the regulatory structure.

Given this framework, competitive issues such as the relevance of geographic and product constraints on regulated depositories are linked inextricably to concerns of safety and soundness, and to the profound technological and economic imperatives which have dramatically altered financial markets since 1970.

In the Bank Board's view, continued legislative reform should seek to restore stability in the current system and facilitate market forces in the least restrictive way feasible. While a return to rigid control may be possible, I believe it would be both impractical and counterproductive for the consumer. A market is inherently antagonistic to any system of regulation, and sooner or later, will destroy or profoundly alter any system that does not remain compatible with the market. If regulatory barriers are sufficiently strong, inefficiencies exist which hurt the consumer and the market will simply foster the creation of new institutions or new institutional arrangements, leaving behind clusters of regulated institutions to gradually wither away. The Bank Board believes the better alternative is to reform the regulatory framework and to revise the insurance system and regulatory goals to preserve the benefits of deregulation, while providing an efficient means of controlling risks.

The fundamental principles which must guide any reform are twofold. First, the insurance of depository institutions continues to serve its vital historic function of maintaining public confidence in the financial system, thereby preventing liquidity crisis and protecting the stability of the money supply when institutions fail. Second, although some ultimate federal guarantee is essential for public confidence, reform of the supervisory system should be molded by the principle that market-oriented pricing and management are inherently superior to any form of regulation.

Consistent with these principles, the Bank Board supports an approach which seeks reform to replace direct government control while maintaining public confidence. As outlined in the Board's insurance study recently submitted to the Senate and House Banking Committees, these reforms should address six concerns: (1) measures to increase insured institutions' participation in the market for uninsured deposits and the development of co-insurance or private insurance to increase market discipline associated with financial institutions' acquisition and investment of funds; (2) the development of a partially variable insurance premium based on measurable risks; (3) ensuring that adequate capital is maintained in thrift institutions to limit the risk exposure of the FSLIC; (4) the development of an improved reporting framework designed to provide meaningful management and financial information, combined with substantially expanded disclosure requirements, to facilitate the reforms listed above; (5) taking an active role in holding institutions' officers and directors responsible for prudent stewardship of the deposits insured by the FSLIC; and (6) the evaluation of the current regulatory structure with regard to its effect on the marketplace and the implementation of regulatory reform designed to allow for more efficient administration of regulatory responsibilities. This latter concern will be addressed in the conclusion of my statement.

INCREASING UNINSURED DEPOSITS AND CO-INSURANCE

Each of these reforms is designed to subject managerial risk decisions to market discipline. Thus, the increased participation by institutions in the market for uninsured deposits will encourage more prudent decisions because the price of uninsured deposits will reflect perceived risk.

A related complementary alternative to regulatory control is the transfer in whole or part of the reliance on the deposit insurance system to the commercial insurance industry. Through premium pricing and other forms of competitive pressure, private insurance should provide incentives to manage risk. Under the current system, FSLIC totally insures deposits regardless of the riskiness of investment activities conducted by an association. Consequently, depositors, investors, and creditors of insured institutions provide no market discipline to management. Development of a co-insurance approach involving either uninsured or privately insured funds, combined with more complete disclosure requirements on the part of financial institutions, could insure rational allocation of funds and bring market discipline to the depository institutions market.

Specifically, a more comprehensive private deposit insurance system could have three important benefits. First, private insurers could be expected to utilize an improved body of information to develop insurability standards and prices creating direct economic incentives for prudent management. Second, the market itself would presumably act to price deposit insurance to eliminate subsidies or adverse incentives for risk taking inherent in the current system. Third, allowing the market to set the price for insurance presumably would create greater economic efficiency, reduce unintended side-effects of government sponsorship, and forestall a drain on federal assets in all but the most severe financial crisis.

VARIABLE RATE INSURANCE PREMIUMS

Second, the Bank Board advocates adoption of a risk-sensitive deposit insurance premium. Such a premium structure will stabilize the process of deregulation by restoring the link between risks and costs. Such a premium structure would also increase efficiency and equity by distributing the highest costs to the riskiest conduct. Under the present system, aggressive risk-taking institutions may be imposing risks far beyond the level of their insurance premiums, while institutions pursuing a more conservative course, both in interest rate and default risk, may be paying excessive premiums. In effect, the flat rate deposit insurance coverage creates perverse incentives for management to engage in the riskiest ventures to obtain the highest return.

To encourage prudent management risk, the Bank Board believes that variable rate premiums initially should be assessed primarily on the bases of interest rate risk, default risk, and real net worth. An insurance premium that increases in proportion to the maturity mismatch of an institution's portfolio, or that declines as the creditworthiness of the portfolio increases, will encourage prudent management of interest rate risk and underwriting.

CAPITAL ADEQUACY

A third reform necesary to supplement alternatives to direct control is the adoption of measures to improve the capital adequacy of thrifts. The Bank Board believes that thrift institutions should have the maximum ability to obtain new equity risk capital for their institutions. This capital provides the greatest safeguards to the FSLIC and is the most effective way of ensuring some management accountability. The Bank Board therefore intends to facilitate the ability of mutual institutions to convert to stock form in the easiest and most efficient manner feasible. In addition, the Bank Board will continue to approve acquisitions of thrifts by non-depository companies, as such acquisitions have for many years provided an effective additional means of bringing new capital into the industry.

The maintenance of adequate capital in thrift institutions in also essential to limit the FSLIC's risk to prudent levels. Because the net worth of an S&L initially absorbs operating losses, improving the capital adequacy of S&L would reduce the burden on the FSLIC fund by reducing the likelihood of S&L failures. The existence of risk capital subordinate to the FSLIC deposit guarantee thus helps us return to a market incentive approach.

FINANCIAL REPORTING

Fourth, improved reporting and disclosure of the condition of financial institutions is essential to render effective all the reforms designed to replace direct government control with marketplace discipline. Timely and frequent disclosure, as well as appropriate reporting of current value financial information, will permit uninsured depositors to evaluate risk continuously, and manage their assets accordingly.

More accurate information would also be crucial to private insurers in developing the most rational and efficient insurance standards and prices. Finally, improved reporting and disclosure will enhance the efficiency of variable rate premiums designed to vary with risk and equity. Because the current reporting system does not provide adequate information on an S&L's risk or the market value of its equity, the Bank Board is revising the system to improve estimates of each association's condition. Improving the quality and extent of information on the economic value of S&Ls provided to the FSLIC would also improve the FSLIC's ability to resolve problems. With better information, the FSLIC can improve the timing of its actions and the sophistication of its selection of a financial assistance procedure.

OFFICERS' & DIRECTORS' RESPONSIBILITIES

As a means of supplementing the reforms designed to emulate market discipline, the Bank Board also has adopted a policy of aggressively pursuing managers who breach their fiduciary responsibilities, imperiling the soundness of their institutions and uninsured depositors' funds. As Congress and the Bank Board have removed legislative and regulatory controls on S&L operations, the obligation to act responsibly and knowledgeably falls directly on the managers and directors of those institutions. Failure to take such action in the past has weakened the discipline associated with operating a financial institution. Thus, managers unwilling to accept self-discipline should be subject to swift and predictable compliance measures.

PRODUCT CONSTRAINTS ON DEPOSITORY INSTITUTIONS

The Bank Board believes that Congress and the financial institutions' supervisory agencies should address the five issues outlined above in conjunction with or prior to taking any action which might further destabilize the regulated financial industry. However, as structural equilibrium is achieved, the Bank Board supports the goal of providing complete competitive parity to all players in financial markets. By allowing all institutions to determine whether and to what degree they wish to specialize, further deregulation will ultimately benefit the users of financial intermediaries--the public.

The Bank Board also believes there is an urgent need to address the competitive anomalies created by rigid product and geographic controls on bank and thrift activities. Nonregulated firms now offer consumers a single package of services ranging from household appliances to brokerage services and the economic equivalent of demand deposit accounts with instant liquidity. It is supremely ironic that Glass-Steagall and other banking laws have permitted increasing penetration by securities firms into services once the exclusive province of regulated depositories, while serving as a barrier to corresponding expansion by banks and potentially by thrifts as well. This irony is the result of modern technological and economic imperatives which have undermined a legal structure designed to operate in the 1930's.

In accord with the Bank Board's belief that a free market is the most efficient means of determining what products an institution should offer, the Bank Board strongly encourages Congress to rectify the competitive imbalance caused by product restraints on regulated financial institutions. This should be done not by restraining and regulating nonregulated firms so as to prevent them from providing such a full range of services to the public, but by broadening and modernizing the range of financial services that are permissible for regulated depositories.

Haphazard deregulation is also occurring through state initiatives. In the past few months, roughly a dozen bank deregulatory bills have been approved in state legislatures, and many more are expected to be introduced soon. These measures generally give state-chartered banks greatly expanded powers to underwrite, sell and distribute all forms of securities and debt instruments. Uniform federal standards are highly desirable to avert further competitive inequities produced by such piecemeal reform.

The Administration proposal modifying the Glass-Steagall Act and other banking and securities laws, to allow banks to offer securities and other nonbank financial services, provides a useful starting point for legislative reform in this area. While the Bank Board fully supports the purpose of the Treasury proposal, we believe expansion is absolutely necessary to address thrift activities. A reform of product constraints only for banks and bank holding companies alone will not be the most efficient way to restore competitive parity throughout the regulated financial industry. In particular, recent litigation has created a question concerning the applicability of the Glass-Steagall Act to thrifts. Thus, while it has been the Board's view that the law does not reach thrift activities to the same degree as those of member commercial banks, clarification of these questions would discourage further dilatory litigation in this area. We would therefore support a clarification of Glass-Steagall to remove this uncertainty.

In brief summary, the Treasury proposal would enable banks to offer nonbank financial services currently available only from other financial organizations. To this end, the proposal would amend the Bank Holding Company Act and certain other laws to permit bank holding companies, through subsidiaries, to engage in any activities the Federal Reserve Board determines by regulation to be "of a financial nature." In interpreting this phrase, the Board is directed to give primary consideration to the public benefits that would result from increased competition in the financial services industry.

Additionally, the proposal would expressly authorize bank holding company subsidiaries to engage in insurance underwriting and brokerage, and real estate investment development and brokerage. As to securities activities, the proposal would authorize bank holding company subsidiaries to deal in and underwrite U.S. and most state and municipal securities, including revenue bonds. Subsidiaries could also sponsor, control, and advise mutual funds and underwrite and distribute their securities. To insulate banks from the riskiness associated with these securities activities, the Treasury proposal would provide that new activities would have to be conducted through securities subsidiaries of the bank holding company, as would all securities brokerage, underwriting, and dealing activities already carried on by the bank. The provision requiring securities activities to be conducted in a separate bank holding subsidiary is also designed to equalize tax and cost advantages which banks have in the private financial markets, and which may derive from their ability to use deposit funds to make a direct equity investment in a bank subsidiary.

Our principal concern with the Treasury proposal is that it could increase existing competitive disparities between thrifts and banks. The Garn-St Germain Act significantly increased the investment powers of federal savings and loan associations, and provided authority to offer money market deposit accounts. However, savings and loans are still barred from such bank activities as offering consumer checking accounts, and are subject to percentage limitations on their commercial loan investment authority which have no parallel in banking laws. Moreover, savings and loans have no authority directly to underwrite state or local obligations of any kind, while banks are authorized to participate in the state and local general obligations market under 12 U.S.C. § 24(7).

More specifically, the securities activities permitted bank holding companies in the Treasury proposal would be far more comprehensive than the activities now authorized for multiple savings and loan holding companies. Although unitary S&L holding companies may engage in securities activities, multiple S&L holding companies are not permitted to engage in underwriting and distribution of the sorts of securities that bank securities affiliates could deal in under Treasury's proposal. Moreover, the Garn-St Germain Act sharply limits the activities of unitary S&L holding companies and their subsidiaries if the holding company owns a thrift with an asset composition similar to that of a commercial bank which would disqualify it as a domestic building and loan association under Section 7701(a)(19) of the Internal Revenue Code. In such a case, the activities of a unitary savings and loan holding company are limited in the same manner as those of a multiple savings and loan holding company.

Similarly, while the Board has authorized savings and loans to conduct certain limited securities brokerage activities through third tier service corporations, opponents of the Board's authorizations have cited alleged ambiguities in the Glass-Stegall Act in litigation challenging this activity. Until the resolution of this legal issue, the threat of litigation poses a significant obstacle if savings and loan companies or S&L's, through their service corporations, wish to compete with bank securities affiliates.

To achieve competitive equity in the securities area, we strongly recommend modifying the Treasury proposal to confer on savings and loan holding companies and savings and loans the same securities and other nonbank financial powers proposed to be provided to banks and bank holding companies.

We would also support modifications which would address the structural difference in the proposal between authorities which will be available to the commercial banking and thrift industries. As the Treasury proposal is now drafted, an extension of its terms would cover only savings and loans with less than $100 million in assets, or which were owned by multiple savings and loans holding companies or unitary savings and loans holding companies. Because more than 75% of savings and loans are mutual in form, the bill would still disadvantage a majority of savings and loans in this country. The Bank Board therefore strongly recommends modifying the proposal to allow mutual and non-holding company, small stock savings and loans to engage in securities activities through special securities subsidiaries corresponding to the proposed bank securities affiliates, while stock savings and loans owned by holding companies could conduct activities through affiliated subsidiaries.

In passing, I would also like to note our concern with the primary rationale for the Treasury proposal's requirement of a separate affiliate to conduct securities activities. As noted earlier, Treasury's chief concern is that banks should not engage directly in activities that are potentially riskier than the banking business. In Treasury's opinion, such conduct would place a supervisory and insurance burden on the federal government that was not intended. In last year's hearing on the Treasury proposal before this Committee, a number of experts offered conflicting testimony on the necessity of using a separate subsidiary as a means of risk insulation. Without attempting to resolve this debate, I think it is important to note that the reform of the insurance system, as I have outlined today, would substantially ameliorate any perceived additional burden on regulators resulting from bank's or thrifts' direct participation in additional "nonbank" activities.

INTERSTATE BANKING

Geographic restraints on the activities of regulated depositories represent another area in which nonbank firms have used rapid technological developments and an outmoded legal framework to gain substantial competitive advantages. Consequently, we have a situation today where, as a practical matter, all financial corporations except commercial banks and thrifts are legally able to conduct all aspects of their business on a nation-wide basis.

With the exception of provisions in the Garn-St Germain Act allowing interstate mergers of failing institutions, the McFadden Act and the Douglas Amendment to the Bank Holding Company Act still constrain banks' geographic expansion. Similarly, with the enactment of the Garn-St Germain Act, federal thrifts that maximize the use of their new investment powers and lose their special tax status can branch interstate only in those states that permit such penetration by out-of-state thrifts. While federal thrifts with existing interstate branches are grandfathered, the new statutory limit exacerbates competitive disparities between thrifts and nonbanking firms.

Given these considerations, the Bank Board supports Congressional action to eliminate restrictions on geographic expansion by regulated depositories. Unless Congress acts to provide these institutions with the same flexibility in both product and geographic expansion that nonbank firms enjoy, the regulated financial industry will inevitably grow weaker. In the current marketplace, both product and geographic restrictions serve primarily to repress efficient competition; removing such barriers would bring great benefits in consumer service and convenience.

"NONBANK" BANKS

Over the last three years, the bank regulators have made several legal and policy decisions affecting the Bank Holding Company Act, allowing the development of "nonbank" banks. Nonbank banks are commercial banks with either national or state bank charters that elect to abstain either from accepting demand deposits or making commercial loans - two activities in which a company must engage in order to fall within the definition of a bank for Bank Holding Company Act purposes. Commercial and industrial firms have thus acquired nonbank banks, acquisitions which would otherwise be barred by the Bank Holding Company Act.

To reduce the pressure of escalating marketplace innovations at the national level that could preempt Congressional debate on reform, the Comptroller of the Currency has imposed a moratorium on approving such applications. The moratorium will run until January 1, 1984.

With respect to the question of extending the spirit of such a moratorium to the acquisition of thrifts by non-thrift diversified financial or industrial companies, the Board has serious reservations about imposing such an administrative ban for several reasons. First, from a legal standpoint, the Savings and Loan Holding Company Act provides us with no clear rationale for denying such acquisitions by companies which would become unitary savings and loan holding companies.

Indeed, throughout the fifty years that the Federal thrift system has been in existence, non-financial and non-depository corporations, whether steel manufacturers or investment bankers, have had the authority to acquire thrifts. Many such acquisitions have occurred throughout this period with little fanfare and no disruption to the system. Second, the Bank Board has seen no evidence that the ownership of thrifts by non-depository corporations or non-financial services firms has ever caused a serious problem in the industry or its regulation. No abuse in this area has been documented. Third, any moratorium to restrain the acquisition of thrifts by non-depository corporations and non-financial services firms would raise the erroneous implication that such acquisitions had caused substantial and insurmountable industry and regulatory difficulties. That is simply not true. Fourth, acquisitions of thrifts by such firms bring into the industry new capital which can support and invigorate both ailing and healthy thrifts in this very competitive market.

In short, there appears to be little basis in sound policy for such a moratorium after fifty years of success. During its deliberations on the Garn-St Germain Act, Congress had the unitary S&L holding company issue before it. Congress unequivocally decided that, as long as an insured institution meets the asset composition test specified for domestic building and loan associations under section 7701(a)(19) of the Internal Revenue Code, it may be owned by any company. Likewise, by exempting thrifts from the Bank Holding Company Act definition of a bank, Congress made an additional positive comment on the continued appropriateness of the activities restraints contained in the S&L Holding Company Act. When it passed the Garn-St Germain Act, Congress clearly knew of the existence of the S&L Holding Company Act and the opportunities for thrift acquisition that it provides. Congress also clearly understood the progressive changes it made to the authorities of a federal thrift in the Garn-St Germain Act and how attractive that charter could become to new capital. It is inconceivable that Congress, in its wisdom, did not explicitly design these circumstances with the public interest in mind. Thus it seems unreasonable and hasty to call for a repeal of the Garn-St Germain Act approximately six months after its effective date because of conceptual and legal gaps in the commercial bank statutes that have been understood for nearly three years.

While the Board believes a moratorium on thrift acquisitions would be inappropriate at this time, we would welcome further discussions on this issue with the Committee. Indeed, the acquisition of thrifts by non-financial corporations may continue to provide both Congress and the regulators with experience on an experimental basis which may be helpful to the redesigning of the banking laws.

REGULATORY REFORM

As deregulation proceeds, advocates of reform must question whether the current regulatory framework is duplicative and inefficient. The current system evolved in a piecemeal way, and incorporates many areas of overlapping and parallel jurisdiction. This overlapping has produced conflicts among regulators themselves, as each seeks to implement differing statutory objectives, and has provoked complaints from the industry of burdensome overregulation.

While competitive pressure from the non-regulated sector has increased the push for regulatory consolidation, it is unclear if consolidation would in fact reduce duplication, administrative costs, or regulatory burdens. By far the most significant costs of financial regulation stem from effects that the regulations themselves have on the marketplace, whether for good or bad. Therefore, an evaluation of these effects must guide the process of regulatory reform.

The Bank Board believes that while the goal of regulatory reorganization is valid, dismantling of the current regulatory structure would be of doubtful benefit at the current time. Despite the reforms made to thrift powers by the Garn-St Germain Act, there are still substantial differences between the legal authority and product orientation of the thrift and commercial banking industries. While these divergences exist, there are advantages to maintaining separate supervisory authorities for banks and thrifts. Thus, deregulation has to continue, under revised goals or while the goals are being revised, before agency consolidation makes much sense.

This is particularly true given the sharp differences between the current system for insuring and regulating savings and loans, and that for commercial banks. The responsibility for chartering, insuring, examining and supervising commercial banks is divided among three agencies at the federal level; the Bank Board combines all these functions in a single entity for supervising savings and loans. Consequently, the structure for savings and loans has proved invaluable in allowing the Bank Board to fulfill its responsibilities during a period of great crisis in the industry. First, the combination of these functions in the Bank Board has proved highly beneficial because it compels the Board to examine all of our regulatory actions from a balanced perspective as charterer, insurer and liquidity source. Perhaps most important, the Board's structure permitted great gains in dealing with weakened institutions in a cost-effective, timely, coordinated manner, and with a minimum of staff.

In sharp contrast, federal resolution of a failing bank requires coordination by the Comptroller of the Currency, the Federal Reserve Board, and the Federal Deposit Insurance Corporation, all of which may have different objectives and philosophies. Consequently, coordinated action is sometimes slow and difficult to achieve.

The efficiencies and benefits inherent in the Bank Board's structure would also result from a merger of commercial bank regulatory functions now vested in the OCC, FDIC, and FRB. A similar assignment to the Bank Board of all remaining regulatees or a broader range of regulatees would avoid the problems inherent in a system that lodges all financial regulation in one "super agency." And if at some point, the activities of both groups of regulatees become essentially identical, it would then be appropriate to consider consolidation of these remaining federal regulators.

Without such a substantial blurring of functions, however, we doubt that a wholesale merger of thrift and banking regulators would result in any appreciable efficiencies. In all likelihood, an agency with responsibility for regulating two separate industries would be forced to recreate a separate thrift regulatory structure within itself. The regulated industry would still have to deal with its old regulators, but within the context of a larger bureaucracy. Finally, consolidating the insurance functions at this time would destroy the efficiency of the Bank Board's current structure, especially in the supervisory area.

CONCLUSION

Congress and the financial institutions supervisors must take action to restore equilibrium to the regulated financial industry. While the Board fully endorses the goal of removing remaining constraints on product and geographic expansion by regulated depositories, such deregulation should proceed in conjunction with or after revising the regulatory framework. The Bank Board looks forward to working with this Committee to address these vital concerns.

Mr. Chairman, that concludes my testimony. I would be pleased to answer any questions the Committee may have.

Mr. **PRATT**. The perspective of the last 2 years, of course, has been a fascinating one. In sitting with this committee over that time period, I think we can all take some satisfaction in what has been achieved and where we are today relative to what we saw 2 years ago and where we thought we could be. Everything considered, I think things have worked very well, and I believe that this is a reflection of the excellent cooperation between the Congress, the regulatory authorities, and the industry in this particular regard.

Essentially, I think we have two sets of problems that need to be addressed at this time, one that might be called acute, and one that might be called a chronic set of situations.

First, I think the situation we find ourselves in is a rather interesting one. The massive changes of the last few years in terms of deregulation have led to an entirely new circumstance in financial institutions. This deregulation, as far as the thrifts are concerned, has occurred on two sides. First, this has been the deregulation on the liability side through the deregulation which the DIDC and the market have imposed, including the deregulation of the interest rate paid on savings accounts and the terms that can be offered for those savings accounts.

At the same time, through the efforts of this body, in the Garn-St Germain bill, the asset side of thrift institutions was deregulated to a substantial extent. In my opinion, the industry would have died without that legislation. It was timely and it was imperative.

I further believe that this deregulation is of immense benefit to the consumer and I share and join in Chairman Isaac's comment in that regard from the previous testimony. Never before in history has the small saver, the small person, the man on the street, had the opportunity to receive a market rate of return on the funds which he has worked so hard to accumulate and to save.

At the same time, all types of institutions are seeking to extend credit to a wider group of individuals and, again, the beneficiary of this competition is the consumer on the street.

In looking at the housing and home finance area, we see a great number of institutions and businesses which seek to get into this business and to provide this credit and the consumer must be the beneficiary of that.

At the same time, this deregulation has outpaced the regulatory authorities and I think that that is a matter for substantial concern. We have disconnected risks and returns on assets in this society. Any institution, no matter how it is run, can obtain funds as if it were the U.S. Government because it is insured by the FSLIC or the FDIC, and the depositor can go to that institution and place his money with it knowing that the U.S. Government stands behind those funds.

PREMIUMS VARY FOR FEDERAL DEPOSIT INSURANCE

At the same time, with the deregulation on the asset side, which is a positive thing and which allows funds to flow where they are most needed, institutions have no explicit controls or reduced explicit controls as to where they invest their funds. As a result of this, among other things, every institution in this country is either paying too much or too little for Federal deposit insurance.

Those that are well-run, well-managed, and manage their risks prudently are obviously paying too much. Those that are poorly run, wish to gamble, wish to expose themselves to inordinate risks, or have inadequate management, are obviously paying substantially less than they should in insurance.

I believe that this is a destabilized situation, that there's a lack of market discipline in the financial institutions operations of this country and that this must be dealt with in a cooperative fashion between the regulators and the Congress and the industry.

The Bank Board itself recently has submitted to the Congress information as to our recommendations for dealing with this. I'll just briefly mention what some of them are.

One, we think that the reporting standards we have for institutions have been, to some extent, misleading in the past. That is, they have not focused on the correct items. We're developing new reporting standards which will give the true value of institutions and the change in their value as they follow various business pursuits.

Second, while we think variable insurance premiums are not the whole answer, we believe the premiums should be variable and they should reflect the risks of institutions and should deal to some extent with the issue I mentioned earlier.

Third, to the extent that all creditors and depositors of institutions are protected, there is no market discipline. There is no mechanism which causes funds to flow to the most productive institutions. There is no mechanism which assures that funds will be used best in society's benefit under a market system. We need to bring in some element of perhaps coinsurance, or risk-sharing, something that causes the market to choose institutions that are well-managed and which are serving their communities and which are adequately managing their risks. We have made some suggestions in that regard.

Along with that coinsurance or risk-sharing or privatization of a portion of the insurance function, there does need to be increased disclosure. At the present time disclosure means nothing. In fact, to some extent, the more disclosure there is, the consumer who sees an inordinately weak institution may seek to put his funds there thinking that they will pay a higher rate of return and knowing that they're insured by the Federal Government. On the other hand, if we move to some coinsurance and some risk-sharing, then disclosure is imperative. If we impose risks on the public, then we must give them the information to choose between institutions.

Capital adequacy in thrift institutions is a major problem and I will address that in a little more detail in a moment. With 75 percent of the industry or so still in a mutual form, getting capital into weakened institutions is extremely difficult. It's a crucial issue and it's one that the Board is working very hard on.

Finally, we are demanding responsibility of financial institutions. With deregulation and financial institutions' management and boards of directors having the right to make decisions, they must also be held responsible for the decisions that they do make. Those institutions which engage in fraud or gross mismanagement will be held accountable for those actions.

Let me move to the regulatory pattern for a moment and make some comments on that.

I think the Federal Home Loan Bank Board presents an interesting regulatory pattern because it incorporates within it the functions which are incorporated in the Federal Reserve, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation. I think the combination of these functions has made it possible for the Federal Home Loan Bank Board to cope with what has been the worst period in the history of thrift institutions in an economical, efficient, and relatively graceful fashion. The combination of the ability to structure a loan, to provide assistance through the insurance corporation, to provide regulatory forebearance, to find merger partners, and to have this under one decisionmaking authority has made great and good commonsense. It's a very efficient, lean and effective regulatory structure that has served this industry and this country extremely well.

It's interesting to note that on the banking side, for at least the last 50 years or so, there have been three regulators regulating one industry. We hear a number of comments talking about combining the Federal Deposit Insurance Corporation and the Federal Savings and Loan Insurance Corporation and yet we have tolerated for 50 years three regulators of one exact institution; that is the commercial bank. I think that any fair investigation would show that the regulatory structure of the thrift business in this country is highly efficient and very effective and that this should be tinkered with only after great thought. I think the comment that if it isn't broken, don't fix it, is a fairly good one.

The FSLIC in the last 2 years handled more problem cases than in the previous 47 years. I don't think that could have been done if we had had to coordinate between two or three agencies.

That brings me to the third topic that I would like to address, and that is the discussion which has been held concerning a moratorium on what's called the nonbank bank issue.

Historically, savings and loan associations have been able to be acquired by any type of business. That is, they have not been limited to being acquired by businesses which could be bank holding companies. Now we are hearing talk of those who would extend a moratorium on nonbank banks, which is desired apparently in the banking industry, to the thrift industry. But there is not a single example of abuse in the 50 years that we have had that authority which has stemmed from this situation.

The savings and loan business has come through the worst 2 years in its history. Its capital is depleted. Its human capital is not yet adequate. It has 10 years of very difficult times ahead of it. We need to preserve the right to bring capital in this industry from all investors who are good businessmen who can bring capital to the table, and who can help assure that this industry, which is so important to our country and provides so much financing to the consumer and to the housing industry of this country, has the right to obtain capital and survive.

Therefore, we would suggest that the savings and loan law regarding holding companies acquisitions works rather well, and that it would be indeed premature to countermand and repeal major portions of the Garn-St Germain bill some few months after it has been passed.

Mr. Chairman, I would be happy to respond to any questions which the committee might have.

The **Chairman**. Thank you, Chairman Pratt.

Mr. Callahan.

STATEMENT OF EDGAR F. CALLAHAN, CHAIRMAN, NATIONAL CREDIT UNION ADMINISTRATION

Mr. CALLAHAN. Good morning, Mr. Chairman.

Mr. Chairman, members of the committee, I am pleased to be here today to discuss the present condition of credit unions including their structure and powers, the role of Federal insurance, the present legal and regulatory environment, and an assessment of the future of the credit union movement.

To begin with, Mr. Chairman, let me categorize the overall condition of credit unions as quite good. The events of the past year have shown that credit unions continue to be remarkably resilient. Their ability to meet dramatic increases in the number of financial competitors, sudden closing of sponsor companies, and fallout from other financial institutions' failures or potential failures underscores the grassroots strength of the basic credit union and the importance of having returned to individual credit unions the maximum flexibility to manage their own affairs.

CREDIT UNION OPERATIONAL STRUCUTURE SATISFACTORY

In summary, credit union operations in a deregulated environment have been most satisfactory.

With respect to credit union structure and powers, I remain convinced that few, if any, changes should be made to the existing credit union operational and regulatory environment.

Federal credit unions will soon be 50 years old. Yet, the vast majority of legislative changes have occurred in only the last 13 years and the bulk of those within the last 6 years. Federal insurance for credit unions and an independent NCUA were not in existence until 1970. It may be time to leave the credit union system as it is for a while and observe the results. So far, the results are pretty good and I am optimistic about the future. Perhaps the biggest threat to credit unions is not competition, but rather the standardization or homogenization of the financial services industry. In the interest of simplification or fairness or efficiency we here in Washington sometimes draft legislation which reads precisely the same wherever possible for banks, savings and loans, and credit unions. I would urge us to avoid this tendency, especially for credit unions. The truth is that credit unions come from a different mold and some 47 million citizens currently enjoy the unique benefits of that mold. I hope we don't inadvertently cast a new one.

Under the subject of Federal insurance, in some aspects, Mr. Chairman, Federal insurance for credit unions is an example of this standardization or homogenization tendency. Unlike banks and savings and loans which received insurance at a time of very poor financial condition, credit unions were given insurance at a time of very good financial health.

Basically, Mr. Chairman, our report shows that credit unions have had and continue to have a vast amount of practical experience with alternatives to Federal insurance. The report documents these efforts and concludes that while Federal insurance is presently serving a vital function, it did, nevertheless, displace many problem-solving efforts throughout the credit union movement. Our recommendations are designed to attempt to capture the best of both systems—Federal and private initiatives.

In terms of the legal and regulatory environment, during 1982, Mr. Chairman, the NCUA Board completed an exhaustive review of all of our regulations. Consistent with safety and soundness considerations, I believe we have removed as many constraints as possible during this past year. Most notable, of course, was the decision to totally deregulate credit union share accounts as to rates, terms, and conditions. I am pleased to report that deregulation really works and has proven to be very cost effective for credit unions, especially as reflected in their cost of funds. At the same time that the decision to deregulate was formed, the Board made a commitment to dramatically increase the frequency of onsite examinations. We feel that increased supervision is an integral part of deregulation.

As I review the legal and regulatory environment, Mr. Chairman, I have no major recommendations to offer to the committee at this time.

On the subject of future direction of credit unions, while "change" may be a common buzzword used in conjunction with forecasting the financial future, I must confess that I do not share this emphasis when looking toward the future direction of credit unions. In fact, the more I look at the future of credit unions, the more I am reminded of their past. My view is one of a continuous improvement in the offering, delivery, and management of the basic credit union services—consumer loans on reasonable terms, systematic savings, and access to these funds. And all delivered in a personalized and convenient manner. I do not view a future where credit unions become more like banks. While we may have seen some similarities in the delivery of services such as automated teller machines, share drafts, credit cards, and others, the basic differences remain and, I believe, will remain.

I hope that the review of these differences given in my written testimony will be of assistance to others in viewing the future credit union direction. I personally feel that the national interests are very well served by a system which directs its $85 billion in resources through 160,000 decisionmakers who in turn insure that it is the local needs in the local area which are being served. I expect to see more of the same basic services and, hopefully, from many more newly chartered credit unions.

This concludes my testimony, Mr. Chairman. I will be glad to answer any questions which you or members of the committee might have.

[Complete statement follows:]

TESTIMONY OF
EDGAR F. CALLAHAN
CHAIRMAN
NATIONAL CREDIT UNION ADMINISTRATION BOARD

Mr. Chairman, members of the Committee I am pleased to be here today to discuss the present condition of credit unions including their structure and powers, the role of federal insurance, the present legal and regulatory environment, and an assessment of the future of the credit union movement.

To begin with, Mr. Chairman, let me categorize the overall condition of credit unions as quite good. The events of the past year have shown that credit unions continue to be remarkably resilient. Their ability to meet dramatic increases in the number of financial competitors, sudden closings of sponsor companies, and fallout from other financial institutions' failures or potential failures underscores the grass roots strength of the basic credit union and the importance of having returned to individual credit unions the maximum flexibility to manage their own affairs. Let me review briefly some of the major indicators of overall credit union condition.

During 1982, Federal credit union growth was quite substantial. Total assets grew 16% to $45.5 billion and total savings grew 17.2% to $41.3 billion. This growth was 4 times that of 1981 and was faster than any other class of financial institution. As a result, credit unions increased their share of the overall consumer savings market from 4.2% to 4.5%.

Due to rather moderate consumer borrowing in 1983, credit union lending sustained a modest increase of 3.1% for a total of loans outstanding of $28 billion. Their share of the total consumer installment credit market remained unchanged over the previous year at 13.8%.

Since savings increased much faster than loans outstanding in 1983, the credit unions used their excess savings flow mainly to reduce their borrowings and increase short-term investments. During the year, total notes payable outstanding declined by nearly a third while total investments were up more than 50%. Consequently, credit union liquidity improved markedly during the year. Reflecting these trends, the loan to asset ratio dropped sharply to 61.8% from nearly 70% at yearend 1981 while total investments comprised 33.4% of assets in contrast to about 26% a year earlier.

In other areas of operations, credit union capital (total reserves and retained earnings) increased by 14.7% and their capital to asset ratio was 6.7%. Federal credit union net earnings increased 10.7% to $244 million.

In the area of problem credit unions, Mr. Chairman, we also saw substantial progress. Our examiners assign a condition rating to each Federal credit union using a code from 1 - 5. Codes 4 and 5 are assigned to those credit unions having serious problems. During 1982, there was a 12% reduction in the number of credit unions in these two categories. These 788 Federal credit unions comprise 7.8% of the total number of Federal credit unions and 6.5% of total assets. An analysis of these credit unions reveals that the vast majority of problem credit unions are in smaller asset categories. As a precaution, all of the larger credit unions (54 are over $10 million) are monitored by regional and field staff on a continual basis.

In summary, credit union operations in a deregulated environment have been most satisfactory.

Structure and Powers

In preparation for the Garn-St Germain Act last year, a thorough review of Federal credit union structure and powers was completed. It was generally agreed that, with certain structural changes to internal credit union operations, certain refinements of existing powers, and additional regulatory improvements and authorities for NCUA, credit unions and their Federal regulator would be best positioned to meet the forseeable future. With all of these legislative requests now firmly secured by the Garn-St Germain Act, I remain convinced that few, if any, changes should be made to the existing credit union operational and regulatory environment.

Federal credit unions will soon be 50 years old. Yet, the vast majority of legislative changes have occurred in only the last 13 years and the bulk of those within the last 6 years. Federal insurance for credit unions and an independent NCUA were not in existence until 1970. The only major expansion of powers for Federal credit unions is just now 6 years old. P.L. 95-22 was signed on April 19, 1977 and permitted Federal credit unions such authorities as share certificates, lines of credit, longer term real estate loans, and expanded investment authority. The year 1978 brought formal endorsement of the credit union share draft program, the Central Liquidity Facility, and our present 3 person NCUA Board. Finally, 1982 brought the further refinements to these existing authorities.

Mr. Chairman, in my opinion, it's time to leave the credit union system as it is for awhile and observe the results. So far, the results are pretty good and I am optimistic about the future. Now I know that these hearings are addressing many potential changes in other segments of the financial industry and I certainly agree that many are probably needed. My only concern is that when financial industry changes are contemplated, there will be a tendency to somehow apply these changes to credit unions. Perhaps the biggest threat to credit unions is not competition, but rather the standardization or homogenization of the financial services industry. In the interest of simplification, or fairness, or efficiency, we here in Washington sometimes draft legislation which reads precisely the same wherever possible for banks, savings and loans, and credit unions. I would urge us to avoid this tendency, especially for credit unions. The truth is that credit unions come from a different mold and some 47 million citizens currently enjoy the unique benefits of that mold. I hope we don't inadvertently cast a new one.

Federal Insurance

In some aspects, Mr. Chairman, Federal insurance for credit unions is an example of this standardization or homogenization tendency. Unlike banks and savings and loans which received insurance at a time of very poor financial condition, credit unions were given insurance at a time of very good financial health. As our recent report to you and the Committee indicates, Federal credit unions were opposed to Federal insurance for many years. The reasons given for granting insurance in 1971 were based not on need but rather on a reward for a job well done and a desire to give credit unions the same treatment afforded other financial institutions. As the House Banking Committee Report (HRpt 91-1457) states: "Your Committee wishes to make clear that this legislation is designed solely to give credit unions the same insurance afforded other federally chartered institutions and should be considered as a reward for an outstanding job performed by credit unions." The Committee goes on to point out that, at that time, credit unions were "in perhaps their strongest financial condition in history."

Basically, Mr. Chairman, our report shows that credit unions have had and continue to have a vast amount of practical experience with alternatives to Federal insurance. For example, there are presently 16 private insurance funds insuring over 3,150 state credit unions with total shares in excess of $12.3 billion. The report documents these efforts and concludes that while Federal insurance is presently serving a vital function, it did, nevertheless, displace many problem solving efforts throughout the credit union movement. Our recommendations are designed to attempt to capture the best of both systems - federal and private initiatives.

We believe that the National Credit Union Share Insurance Fund should continue its role of providing insurance at the federal level, but that risk rating is best done in the private sector. Therefore our first recommendation is one which I offered before this Committee in October of 1981: namely, that Federal credit unions be given a choice of the type of insurance they purchase. The other recommendations and findings contained in our study are as follows:

> That at least one share of each member account in a Federally insured credit union should be uninsured;
>
> That NCUA would have no objection to lowering the $100,000 coverage for all institutions;
>
> That, in consultation with the credit union movement, credit unions be given the opportunity to capitalize their insurance fund by maintaining a deposit of 1% of insured shares;
>
> That, with the insurance thusly capitalized, risk rating not be used;
>
> That the existing insurance structure is adequate for corporate credit unions, but that NCUA be given authority to issue separate rules for corporates should it become necessary;
>
> That existing credit union disclosure is adequate, but that voluntary efforts by individual credit unions to better inform their members be encouraged; and finally
>
> That NCUA is opposed to consolidation of the Share Insurance Funds.

We believe these recommendations will ensure that individual credit union boards of directors will continue to retain the decision making authority for best meeting the interests of their members and that confidence is maintained in the credit union system. Specific insurance legislative recommendations will be developed in the near future and delivered to the Committee.

Legal and Regulatory Environment

During 1982, Mr. Chairman, the NCUA Board completed an exhaustive review of all of our regulations. Our approach was rather basic; if the regulation could not be justified, consider removing it. Our thinking centered around the fact that credit unions, along with other financial institutions, were in the midst of financial change of such a magnitude that outdated regulations could possibly handcuff an institution which truly needed the freedom to adjust to local market changes. Consistent with safety and soundness considerations, I believe we have removed as many constraints as possible during this past year. Most notable, of course, was the decision to totally de-regulate credit union share accounts as to rates, terms, and conditions. I am pleased to report that deregulation really works and has proven to be very cost effective for credit unions, especially as reflected in their cost of funds. At the same time that the decision to deregulate was formed, the Board made a commitment to dramatically increase the frequency of on-site examinations. We feel that increased supervision is an integral part of deregulation. I am pleased to inform the Committee that our Regional Directors reported last month that they have set a goal of completing annual examinations of all Federal credit unions by September 30, 1983.

In addition to the annual examination, we sent to all Federal credit unions in late March their first Financial Performance Report. This report is based on data submitted to NCUA over the past five years and should allow credit unions to look at their conditions from a different perspective. Not only will they be able to compare their performance with that of their of peers, but they will also be able to review what we believe are critical ratios; such as expenses, reserves, market growth, and delinquencies and receive an objective evaluation of their results in each ratio. We feel this also is an important component of deregulation.

Other components of our deregulation strategy included: an on-site visit to all Federal credit unions during the period from February 16 to March 19, 1982. This "fire drill" exercise was to set the stage for the heightened supervisory presence that is required in a deregulated environment; and a staff reorganization within NCUA to move Central Office personnel resources into the field examination effort. We were able to simultaneously increase our examiner force and reduce the overall size of the agency.

Conservatorship Authority

One of the authorities given to NCUA under the Garn-St Germain Act was that of conservatorship. The first use of this authority was made just two weeks ago on April 13. The NCUA Board exercised this authority with respect to a corporate credit union in order to stem a continuing outflow of shares and to protect the interests of the member credit unions as well as those of the Share Insurance Fund. The granting of this authority was most timely as I am convinced that this was by far the best solution to this problem. No members of the corporate lost any money and service is back to normal.

Loan Rates and Branching

Two other areas under legal and regulatory environment, Mr. Chairman, are the matters of branching and loan rate ceilings.

Since the Committee has indicated that interstate operations of depository institutions will be examined, I thought the members might find useful a brief review of Federal credit union branching provisions. Section 101(9) of the Federal Credit Union Act (12 U.S.C. §1752) defines the "branch" as follows:

> "--any branch credit union, branch office, branch agency, additional office, or any branch place of business located in any State of the United States, the District of Columbia, the several territories, including the trust territories, and the Panama Canal Zone, or the Commonwealth of Puerto Rico, at which member accounts are established or money lent. The term "branch" also includes a suboffice, operated by a Federal credit union or by a credit union authorized by the Department of Defense, located on an American military installation in a foreign country or in the territories of the United States."

The statute contains no other references to branches except to require in Sec. 120(b)(4) (12 U.S.C. §1765) that a credit union in involuntary liquidation shall publicize notice in a newspaper located in each county in which the credit union maintained an office or branch.

Essentially, Mr. Chairman, a Federal credit union may utilize whatever branch or office might be necessary to serve its members. NCUA leaves the establishment of additional offices up to the credit union and this policy has worked very well. Since a branch does not serve the general public, but rather a remote pocket or group of members, there is no reason to recommend change. Therefore, I would suggest that Federal credit union branching remain unchanged.

With respect to the Federal credit union loan rate ceiling, I would reiterate my testimony during your hearings on April 12, concerning S. 730. NCUA supports the provisions of S. 730, but in the meantime, we are confronted with the existing loan rate provisions. As you know, the NCUA Board met on March 10, 1982 and continued the loan rate ceiling at 21% for a period of 18 months. If the NCUA Board does nothing, the ceiling will automatically drop to 15% on September 5, 1983.

The Board does not feel that credit union boards of directors should have to wait until the last minute to know what is to transpire regarding the ceiling. Therefore, the NCUA Board will meet on May 12, 1983, and formally consider the matter of the loan rate ceiling. In accordance with the provisions of Sec. 310 of P.L. 96-221, we have initiated the consultation of the Federal financial institutions regulatory agencies, the Department of Treasury, and the appropriate committees of the Congress - including, of course, this Committee.

As I review the legal and regulatory environment, Mr. Chairman, I have no major recommendations to offer to the

Committee at this time. I will offer, later in this testimony, one amendment to the Federal Credit Union Act which we feel must be considered by the Committee.

Future Direction of Credit Unions

While "change" may be a common buzzword used in conjunction with forecasting the financial future, I must confess that I do not share this emphasis when looking toward the future direction of credit unions. In fact, the more I look at future credit union directions, the more I am reminded of their past. My view is one of a continuous improvement in the offering, delivery, and management of the basic credit union services -- consumer loans on reasonable terms, systematic savings, and access to these funds. And all delivered in a personalized and convenient manner. I simply do not see the vast majority of credit unions trying to be all things to all of their members. Rather,their future appears to me to lie in the close relationship with their members. This is what produces the trust and confidence of individual members that their basic financial needs of borrowing and saving will be met.

Mr. Chairman, I do not view a future where credit unions become more like banks. While we may have seen some similarities in the delivery of services such as automated teller machines, share drafts, credit cards, and others, the basic differences remain and, I believe, will remain. Let me share with the Committee those differences which are very fundamental and which will continue into the future. Credit unions:

1. Are not for profit cooperatives and have only one vote per member.
2. Have no capital requirement for start-up - nor a "convenience and needs" test.
3. Do not deal with the general public.
4. Are more numerous (20,500) than all other institutions combined. They remain quite small. 70% are under $2 million.
5. Are not subject to the DIDC. Savings rates are totally deregulated.
6. Are limited by statute to consumer saving and lending.
7. Usually have 95% of their assets in loans.
8. Use the practice of interest refunds to balance the interests of the borrowers with those of the savers.
9. Are considered an employee fringe benefit and often get free office space and other services from a sponsoring organization.
10. Very often provide member education and financial counseling.
11. Were given a Federal tax exempt status.
12. Rely very heavily on the use of volunteerism in the running of the credit union. The compensation study mandated by the Garn-St Germain Act revealed continued credit union support for the non-payment of credit union officials.
13. Have no branching restrictions.

14. Have a different reserve structure than other financial institutions.
15. Make a much more complete disclosure of financial condition to their members.
16. Have a democratically elected board which sets savings and lending rates and terms for the membership.

I hope that a review of these differences will be of assistance to others in viewing the future credit union direction. I personally feel that the national interests are very well served by a system which directs its $85 billion in resources through 160,000 decision-makers who in turn ensure that it is the local needs in the local area which are being served. I expect to see more of the same basic services and, hopefully, from many more newly chartered credit unions.

Federal Credit Union Act Amendment

In closing, Mr. Chairman, let me again offer an amendment to the Federal Credit Union Act which was dropped from the Garn-St Germain Act of last year.

NCUA Central Liquidity Facility Tax Exemption

Due to an oversight in the enactment of Title XVIII of P.L. 95-630, the NCUA Central Liquidity Facility was established within NCUA as a mixed ownership government corporation but without a specific tax exemption. The efforts to obtain this exemption have been somewhat frustrating. We have also been pursuing a ruling by IRS which would grant administrative relief but also with no success.

The taxes paid thus far are as follows: 1980 - $111,400; 1981 - $46,000; and 1982 - $56,800 for a total of $214,300. Further, the 1983 estimates are so signficantly higher as to give us very serious concerns. The NCUA Board has adopted a policy for the CLF to aggressively build up its reserves this year to reach an adequate equity base essential in carrying out its mandate of meeting liquidity needs of credit unions. Due to this reserve buildup, we estimate our tax liability for 1983 to be $400,000 - $500,000.

We ask you, Mr. Chairman, to again introduce this correcting amendment and we will be pleased to assist your efforts to secure enactment. We have attached a copy of this amendment which includes the latest corrections made by the Department of Treasury. (Enclosure 1) _

This concludes my testimony, Mr. Chairman, I will be glad to answer any questions which you or members of the Committee might have.

A BILL

To amend the Federal Credit Union Act to provide a tax exemption for the National Credit Union Central Liquidity Facility.

SEC. 101. Title III of the Federal Credit Union Act (12 U.S.C. 1795 et seq.) is amended:

(1) by inserting in Sec. 303 the words ", an instrumentality of the United States," between the words "Facility" and "shall" in the second sentence; and

(2) by adding the following new section at the end of thereof:

"TAX EXEMPTION

"SEC. 311. (a) The Central Liquidity Facility, its franchise, activities, capital reserves, surplus, and income shall be exempt from all Federal, State, and local taxation now or hereafter imposed, other than taxes on real property held by the Facility (to the same extent, according to its value, as other similar property held by other persons is taxed).

"(b) The notes, bonds, debentures, and other obligations issued on behalf of the Central Liquidity Facility and the income therefrom shall be exempt from all Federal, State, and local taxation now or hereafter imposed, provided, that--

(1) interest upon such obligations, and gain from the sale or other disposition of such obligations shall not have any Federal income tax or other Federal tax exemption, as such, and loss from the sale or other disposition of such obligations shall not have any special treatment, as such, under the Internal Revenue Code of 1954, or laws amendatory or supplementary thereto, except as specifically provided therein; and

(2) any such obligations shall not be exempt from Federal, State, or local gift, estate, inheritence, legacy, succession, or other wealth transfer taxes."

"(c) For the purposes of this section--

(1) the term 'State' includes the District of Columbia; and

(2) taxes imposed by counties or municipalities, or any territory, dependency, or possession of the United States shall be treated as local taxes.".

SEC. 102. The amendments made by this Act shall take effect on October 1, 1979.

Enclosure 1

The **Chairman**. Thank you very much, Chairman Callahan.

Chairman Pratt, on page 16 of your testimony you oppose imposing a moratorium on the acquisition of thrifts by diversified industrial companies, a moratorium which would be similar to that imposed by the Comptroller of the Currency and we discussed at great length earlier.

However, yesterday Chairman Volcker stated that thrifts could easily be substituted for banks as a vehicle by which these companies can expand in the traditional depository area.

LOOPHOLE IN BANK HOLDING COMPANY ACT

Would you agree that there is a loophole in the Bank Holding Company Act that with the moratorium those companies desiring to get into the business will just purchase a thrift? Don't we just direct more concentration toward acquiring of thrifts?

Mr. **Pratt**. Well, Mr. Chairman, in addressing that I attempted to point out that the law has always read as it does now. And, as you know, a number of these companies have acquired thrifts and, as you also know, they operate them as thrifts and I have seen no evidence of any abuse whatsoever.

We continually hear testimony about the evils of any such action of this type, and yet I think the thrift industry is a very good example of the fact that those evils do not seem to have occurred. In fact, I'm not sure what the evils are. I hear bank regulators and others commenting about what a bad type of development that would be, but their arguments seem to be much more in the general rather than the specific.

As I also mentioned, I think that thanks to the Garn-St Germain bill, the thrift charter is a valuable charter today. This industry needs an immense amount of capital. If we don't get it from private sources, we are going to get it from Congress or from the American people in one fashion or another, and I would prefer to see that private investment.

I see the inclusion of thrifts in a moraturium as the first step in a substantial attempt to encompass thrifts under bank regulation and I think that that would be premature: the thrifts have a separate culture, a separate history; they're operated separately; and they're capitalized differently Rolling them under bank law and regulation by a mechanism such as the moratorium, one, serves no logical purpose and, two, would be counterproductive to the fiscal health of this country and to public policy.

I think that we will see industrial companies and others wanting to acquire thrifts. This has gone on for a very long period of time. In the State of Utah, for example, one of the largest thrifts is owned by an insurance company and has been for years. I think there are something like a dozen thrifts that are owned by insurance companies. This has been in the law for 50 years and I don't see the abuses. But I do see a lot of danger in including thrifts under that moratorium.

The **Chairman**. Well, there is no doubt that it's been in the law for 50 years and the big difference, it appears to me, that's made the thrifts more attractive is prior to last year they didn't have commercial powers. So now these acquisitions—they're not required to divest themselves of the commercial loaning authority.

Doesn't that make the thrift much more attractive?

Mr. **Pratt**. I think that it does. I guess the question that would have to be asked is, What is the abuse that would be perceived by another insurance company or a steel company or a hardware company owning a thrift? The thrift will still be fully regulated by the thrift regulator and it seems to me that one needs to demonstrate a problem associated with the stock being owned by an industrial company.

The **Chairman**. I'm not saying there is any inherent evil. I'm saying if you've got a moratorium on one side by the Comptroller for a period of time and not on the other, does it direct more than normal activity in that direction and give those who acquire the opportunity to control credit with their customers?

Mr. **Pratt**. Well, first, the control of credit would clearly not be tolerated nor allowed. Because the Congress has passed a substantial body of legislation—fair lending practices and other things relating to this issue—I believe no major industrial company or other company, in my opinion, would take over an institution with the hope of unfairly discriminating against some borrowers or diverting that credit. This hasn't been a problem and we don't see it as a problem in the future.

If you look at the number of nonbank banks, I think that it's a handful. If I remember correctly, it's less than a dozen. We're talking about affecting 3,500 thrifts to control a situation that so far apparenty involves a tiny number of commercial bank situations.

Also, the nonbank bank may escape more regulation. By being a nonbank bank, the argument is that it doesn't come under the Bank Holding Company Act. But under well-established savings and loan holding company law, no thrift institution escapes that holding company regulation merely by being acquired by a nonbank holding company entity and no thrift institution escapes any regulation by stripping out a certain class of assets or liabilities.

The **Chairman**. On April 6, there was an article in the Wall Street Journal.

> The Federal Home Loan Bank Board which has authority over thrift acquisitions and charters informally decided that if security houses want to acquire savings institutions they will have to absorb financially troubled ones.

Yet another article on the 25th in the Wall Street Journal indicates that Merrill Lynch has agreed to buy a thrift that is not considered to be troubled.

What is the policy at the Board on this troubled versus nontroubled institution in acquisitions of those that are not in trouble?

Mr. **Pratt**. At this time, the Bank Board has not approved the acquisition of any thrift by an investment banking house. That policy is still under development, but there is no real discussion at this time of approving an acquisition of a thrift by an investment banking house, other than to solve a major FSLIC problem that would save substantial public moneys. And the agreements that you may see in the paper between institutions or private organizations to acquire a savings and loan have no bearing on what will occur. That is, they're subject to the approval of the regulatory agency. Man proposes, but God disposes. I'm not being profane, but the analogy is similar.

The CHAIRMAN. Mr. Callahan, your testimony is somewhat unusual before this committee in that you're not asking for anything. [Laughter.]

You're stating that credit unions are doing pretty well and NCUA is under control and you don't see any changes that are required.

You indicate that there are many credit unions with interstate offices, particularly military credit unions. Are there any community-based credit unions with interstate offices?

Mr. CALLAHAN. Mr. Chairman, not that I'm aware of. The Federal credit union policy would be to limit community credit unions to, first of all, small, rural districts and beyond that in very well defined areas of the larger metropolitan areas.

The CHAIRMAN. Earlier I think you were here and heard Mr. Isaac talk a great deal about market discipline. He indicated disclosure, risk-based premiums and other market discipline instruments were necessary to complement examinations.

You emphasize that you expect NCUA to examine all Federal credit unions on an annual basis. In your view, in the credit union movement, do you have a balance between market discipline and supervision, a proper balance?

Mr. CALLAHAN. Well, Mr. Chairman, we feel that there could possibly be some improvements in this area in terms of market discipline. We take the view that since it is a cooperative movement one of the things that we advocated in our insurance study is that we would introduce market discipline perhaps by changing the law, that it would make perhaps the first share that the member deposits be uninsured. We believe that that sharing of risk would bring market discipline into a credit union and be very consistent with credit union ideals and in the long run be far more effective than other options we looked at.

The CHAIRMAN. Senator Lautenberg.

Senator LAUTENBERG. Thank you, Mr. Chairman.

Mr. Pratt, I read your testimony and I was struck by one thing in particular. That was your agreement with Mr. Isaac about the benefit to the individual in this period of deregulation.

Hasn't it also happened that the character of the borrower or the borrowing has changed considerably?

FIXED RATE LONG-TERM MORTGAGE

How about the mortgage marketplace? S&L's did a huge part of the mortgage business. Do we still see fixed rate, long-term mortgage money available in the same quantities? What's the prospect for the future? The competition for return on investment such that I don't see why anybody would get involved in fixed rate, long-term mortgages. Yet that's so important in the development of homebuilding and our building trades throughout our country.

Mr. PRATT. What we see at this time is an immense move toward a fixed-rate mortgage. In 1981 and 1982, previous to the deregulation and when institutions were getting very little in the way of funds, as I recall—and we'd be happy to supply you with exact figures for the record—the variable rate mortgages were running something like 45 percent of the loans which savings and loans were making. That would mean—and these numbers may be off slightly but at least the direction is correct—that 55 percent of the loans were fixed rate.

[Information subsequently supplied for the record follows:]

The Bank Board collects information about fixed versus variable rate mortgages from the monthly Mortgage Interest Rate Survey (MIRS). Although this survey was established in 1962, it was not until September 1981 that the Board began requesting information about adjustable mortgage loans (AML's) defined as any loan containing a provision for periodic adjustment in the contract rate based on a change in an index specified in the loan contract. The attached table shows the percentage of adjustable rate loans made during the reporting period by federally-insured associations from September 1981 through April 1982. As is evident, adjustable rate loans were running in the 40–46 percent range from the end of December 1981 through October 1982. Recently, the proportion has fallen below 30 percent, as Chairman Pratt testified.

TABLE 1.—Proportion of estimated number of loans closed that are adjustable rate at FSLIC-insured savings and loan associations

1981:	
September	32
October	36
November	38
December	41
1982:	
January	43
February	46
March	47
April	46
May	46
June	42
July	40
August	42
September	40
October	42
November	39
December	38
1983:	
January	37
February	30
March	31
April	29

NOTE.—The first 5 working days of each month.

Senator LAUTENBERG. It used to be 100 percent because the variable rate mortgage was not in existence.

Mr. PRATT. That's correct, but if we look at what has happened with the rapid deregulation that's occurred in the last year and the passage of the Garn-St Germain bill, the percentage of fixed-rate mortgages has gone from 55 to maybe 70 or 75 percent.

So what we see right now is a very, very strong movement toward fixed-rate mortgages and I don't think that would have occurred without the deregulation. Savings and loans were dying. They were atrophying. They had suffered more than 2 years of every consecutive month meeting a savings outflow and they had very little in the way of funds. They rationed those funds very astutely. They insisted on an instrument that was more attractive to them. With the greater flow of funds and the greater competition, they are of course supplying what the consumer wants, and that's the fixed rate mortgage.

It's not without risk to these institutions and I don't think it's an unmixed blessing, but it's a case of the mortgage market having an abundance of funds at this time.

Senator LAUTENBERG. I'm not as optimistic as you are. I can't imagine someone wanting to be out there with a 25- or 30-year paper, fixed rate, except that maybe in this secondary mortgage market there's an opportunity to lay-off some of the risks and some of the responsibility.

Mr. PRATT. Well, the figures are actual figures that I was quoting to you, so that is not a speculation. That is what has happened. I share some of your perceptions that the fixed-rate mortgage has probably been an incredibly mispriced instrument, and that, as it was historically structured, it does seem questionable why institutions would want to be as heavily into it as they are.

Senator LAUTENBERG. I think a change in interest rates will change the attitude. There is no guarantee that interest rates are going to stay as low as they are, and there's not a lot of optimism about them going lower.

TURN TO CONVENTIONAL STOCK OWNERSHIP

You mentioned something about the mutual character of the savings and loan industry interfering with the raising of capital. Does that suggest a recommendation on your part the industry ought to work itself away from the mutual character of ownership and turn more to conventional stock ownership?

Mr. PRATT. I think that that is important if the industry is to continue to serve the public and provide a substantial amount of credit, and we have tried both to protect mutuality for those institutions that feel they have a bona fide reason for retaining it, but to facilitate the ability to convert to a stock institution, and to raise capital which is usually raised in their own community. Most of these are medium-sized institutions and so it is really a community business. We think that it's very important to make it possible for them to raise capital on a relatively easy basis and we have streamlined the conversion regulations immensely in that regard.

Senator LAUTENBERG. Do you think it calls for a change in the type of management from the relatively comfortable situation of a mutual company? You rarely see a contested proxy fight or a turnover of management. I would be interested in your view.

Mr. PRATT. I think that if one takes a little longer time perspective, I would fully agree with the posture that you're pointing out. Historically, these financial institutions were incredibly protected. They were given a geographic monopoly. No one could move into their market area. There were no unregulated competitors to offer a better rate of return to their savers. We didn't have the telecommunications, the computer, the mass media to move money around where the best rate of return could be found, profits were relatively high, and I think business was relatively easy. Thrifts tended to compete by offering premiums, by building impressive physical edifices, great branches, this sort of thing. As a result, the human capital that's really needed for this time of competition wasn't actually developed in many of the institutions and the biggest challenge of the next 5 or 10 years is probably the development of human capital in these institutions to deal with these times.

Senator LAUTENBERG. That also suggests that the role that these institutions play in the community is going to change substantially as a result of deregulation. They will be competing more in the commercial bank area. I think it suggests that the existence of the small S&L may be challenged because I see deregulation fostering bigness, interstate competition. You talked about putting aside the moratorium on acquisition of S&L's and thrift institutions by nonbanks. But at the same time, we've seen now in New Jersey—and we've discussed that here—Merrill Lynch's move to acquire the S&L.

Mr. PRATT. It has not been decided and the present Bank Board policy up to this time would not have been to approve that sort of thing.

Senator LAUTENBERG. Right, but your attitude would therefore change policy.

Mr. PRATT. No; I don't know that that's true. I don't know that I have any answers in that regard. I think we should move very cautiously in that regard and especially where it comes to the waiver of any regulation which would allow the mixing of funds and credit. I don't see making structural changes on a gratuitous basis. The Bank Board could have approved these at any time and has not approved any of them, and would not do so without a very, very thoughtful consideration of all of the issues. And I haven't resolved those issues in my own mind. Of course, that will become a nonrelevant factor here very quickly, but it wasn't in the past.

Senator LAUTENBERG. Your influence will prevail some time after your departure. The fact of the matter is that it seems to me a little inconsistent to say waive the moratorium on one hand, and then be doubtful about your personal view in terms of the acquisition program.

Mr. PRATT. Well, I think a moratorium would be a very sweeping statement by this body that the independent regulation of thrifts, which I think has probably been the finest regulation in this city in the last 2 years, given the number of problems we have had, is to be swept aside on a relatively minor point. No one has demonstrated any problem whatsoever with the acquisition of thrifts. It is not a problem. Nobody has suggested it's a problem or that it has occurred or where it has occurred that it's been a problem, and yet it's to be included in a piece of legislation which is really the first step in combining the regulatory agencies

If Congress wishes to do that, then I think it should be done on a zero-based approach, saying how should regulation look generally, how should we regulate this type of thing, and not by sort of inadvertently changing 50 years of law for one type of institution so that everything is equal between institutions. Financial institutions are not equal. They have different histories, different law, a different culture, and a different service to the community. Until there is a way to make them truly equal, I would resist the sweeping inclusion where no problem is demonstrated.

Senator LAUTENBERG. Are we going to get to come back again, Mr. Chairman?

The CHAIRMAN. Yes, Senator Hawkins.

Senator HAWKINS. Thank you, Mr. Chairman.

Mr. Pratt, you know the Florida community has been shaken by the recent takeover by the Federal Home Loan Bank Board of one of our largest savings institutions. The matter is now in litigation so I won't ask you to comment on the particular case, but it raises several public policy questions in my mind.

One criticism is that the Board did not move promptly enough on the applications of the institution for various recapitalization arrangements.

Do you feel that in the light of current conditions that you've mentioned here today the Board gives sufficient priority to approving recapitalization plans that might save an institution?

Mr. PRATT. Let me first preface my remarks by saying they are not addressed to any specific situation. The Florida situation you mentioned is in litigation and none of my comments should be construed as applying to that as a specific case.

The Bank Board is extremely interested in recapitalization opportunities and has recently promulgated many, many regulations which, for instance, make conversions easier, in every fashion trying to make it easier for an institution to be recapitalized and to bring capital in. For example, the Board has authorized the inclusion of subordinated debt in satisfying net worth requirements, and has liberalized the restrictors regarding the issuance of preferred stock and subordinated debt.

In many cases, what might be called recapitalization applications are either applications for assistance from the Federal Savings and Loan Insurance Corporation. In that particular regard the Federal Home Loan Bank Board has always followed the policy that no existing risk capital or no existing common stockholder of any institution can retain a senior position to the FSLIC if the FSLIC puts in money, that is, if we're going to take the taxpayers' money and put it into an institution, that assistance must be wholly repaid before any of the owners of that company at the time we went in can receive any distribution of income or cash flow. We think that if the Government is going to assist, then the people of the United States should be paid back before those who provided risk capital—that they knew they could lose—should have any participation.

Second, there are many problems associated with the accounting procedures in financial institutions at this time. Historical cost accounting and some other factors don't very well reflect the true financial situation of some institutions. It is possible, for example, to structure deals which may appear to generate profit but are really manipulations of accounting circumstances, and don't increase the safety or soundness of that institution or of the banking system in general.

The Bank Board is reluctant to endorse such programs. Sometimes we see recapitalization proposals which fall into this category, but any bona fide recapitalization proposal, any proposal to bring capital into an institution, any business plan which would seem to increase the probability of survival, gets a very high priority at the Bank Board and we fully support that sort of thing.

Senator HAWKINS. So in your answer you're telling me that you try to balance the interest of the stockholders?

PROTECTION OF PUBLIC IN GENERAL

Mr. **Pratt**. Well, wherever the stockholders' interest can be maintained and still meet what we consider to be good public policy, we will always do that. But we think that good public policy is the protection of the public in general, the protection of the depositors, and the maintenance of the safety and soundness of the Federal Savings and Loan Insurance Corporation.

Senator **Hawkins**. Who comes first in that list?

Mr. **Pratt**. The depositor comes first.

Senator **Hawkins**. What about the insurance fund?

Mr. **Pratt**. The insurance corporation comes second, and the stockholder would have some residual interest on our part. That is, we certainly would not want to disrupt the situation if it was possible following good public policy to avoid it. But it is our interpretation that the Federal Savings and Loan Insurance Corporation is not in the business of insuring stockholders, that it is not in the business of providing financial assistance to stockholders, that they are not insured under the law, nor personally do I think they should be. They should be providers of risk capital and the FSLIC should not have an explicit obligation to them.

Senator **Hawkins**. Bank regulators obviously possess tremendous power in takeover situation. Arbitrary actions can harm innocent people. Do you feel there's a need for procedural safeguards to protect the interest of parties from the arbitrary exercise of this discretionary authority?

Mr. **Pratt**. I think that the system works relatively well at this time. If one looks at the kind of situations that we have been involved in, I think all parties except those who provide risk capital have been well protected. No depositor, no creditor of one of these institutions has lost any funds. The institution reopens the next day. You may have an institution which is insolvent and massively insolvent—$20, $30, $40 million of insolvency. Perhaps it's an indictment of us that we did not move in sooner in some cases but tried to find solutions which would have allowed the continuance of that institution without more drastic changes. However, we have gone to some lengths to try and maintain that continuance and, for instance, to leave stockholders with some residual position if they can obtain it. When we come to the conclusion that that cannot be done, then of course the action appears to be rather dramatic. But I don't think that one can demonstrate that our procedures have either been disruptive or that the parties have been injured; that is, every depositor and every creditor is taken care of. Those offices of these institutions have opened the next day with their employees in place, with the exception of top management.

Senator **Hawkins**. Thank you.

Mr. **Pratt**. Let me say that these processes are painful. They are wrenching. They are destructive of people's lives on an individual basis.

Senator **Hawkins**. Why are they so lengthy?

Mr. **Pratt**. I think that they are lengthy for a lot of reasons. Probably the main underlying reason is that the regulators would like to pursue every less drastic means of resolution before taking some drastic position.

If at the instant an institution became effectively insolvent the regulators instantly moved in, it would certainly shorten the process. I don't know whether that would in fact be better or worse.

The **Chairman**. Senator Riegle.

Senator **Riegle**. I think the questions from the Senator from Florida are important questions and I would like to follow up on some of them. I think you were in the room when I asked Mr. Isaac if they always have an open competition for the takeover of an institution that is in trouble. He said they always do have an open competition and they always go with the highest bidder.

Is that your practice as well?

ANYONE WITH FINANCES CAN BID

Mr. **Pratt**. Our practice would be somewhat different. First, we have solicited on a broad basis anyone that would be interested in acquiring a troubled institution. We have done more interstate operations and we think that those interstate operations have saved an amount probably equal to the total amount of the FSLIC. So we probably go a little broader in casting our net than the FDIC would for its typical situation.

We may also include within that list of bidders some institutions that upon further analysis we may not feel have the financial wherewithal to handle this problem. We perhaps have fewer strong institutions than the FDIC does to deal with in acquiring these institutions. This industry has been weakened in general by the last 2 years. So we would again include a somewhat wider group of people to be invited to the bidders' conference.

Senator **Riegle**. Could anybody ask to come, and will they be included if they express an interest? Do you keep people out?

Mr. **Pratt**. Anyone who could in any legitimate sense acquire the institution would be included.

Senator **Riegle**. Well, legitimate means financial sufficiency.

Mr. **Pratt**. Right.

Senator **Riegle**. If there is financial sufficiency, you do not block anybody?

Mr. **Pratt**. That's correct.

Senator **Riegle**. And there is not a single instance where you have blocked anybody with financial sufficiency from coming in and participating?

Mr. **Pratt**. I think that would be absolutely correct; yes, sir.

Senator **Riegle**. They are invited to the bidders' conferences?

Mr. **Pratt**. Yes, sir. Absolutely.

Senator **Riegle**. No one has been turned away?

Mr. **Pratt**. I can't speak with personal knowledge, but that would certainly be Bank Board policy and I would be happy to check to see if that has ever occurred. I can't imagine that it has, but I will check it out.

Senator **Riegle**. Is the bidding made public? Do we have a way of——

Mr. **Pratt**. No; the bidding is not made public and the bids are not identical in their terms and conditions. One institution may ask for supervisory forebearance on this item and for less money. There may be 50 aspects or more of a bid or 20 or a great number of aspects. Perhaps it would be better to standardize and we've thought about that. We haven't gone to that. We've let the institution prepare the bid with some standardization.

BIDS SHOULD BE PUBLIC

Senator **Riegle**. Why not make it public? Why should this not be out in the open? Why does this have to be done under the cloak of secrecy? Since these are valuable properties, people will come in to make their offers. Why not get this out into the light of day? I just think open competition is a healthy aspect from everybody's point of view. I think it heads off the question of favoritism or third party deals or anything else. Why not have it right out in the open where everybody can see it?

Mr. **Pratt**. Let me say we do publicize and encourage people to come. I would say the reason that we have not made the bids public is that we have felt that we're always in a negotiating stance in these and that we would give an inordinate amount of information to those who would be negotiating against us in future situations.

Senator **Riegle**. Why isn't that a plus? It seems to me what you are after is the highest bid; is that not right?

Mr. **Pratt**. Yes, sir.

Senator **Riegle**. I assume that is what you want.

Mr. **Pratt**. That's correct.

Senator **Riegle**. That is what Mr. Isaac says he is after. It seems to me the more information you have and the more accurate the bidding process, the higher that number is likely to be and the better for all concerned. So, it seems to me the more you impose any secrecy or show an unwillingness to disclose the more likely we end up with something less than the high bid.

Mr. **Pratt**. Well, I think that's one possible interpretation and I would have no real problem in making it public. I would guess that the arguments made on the other side would be that people may not bid because they don't want it made public. They may be exposing some of their own weaknesses in these bids.

Senator **Riegle**. Why don't they get out of the bidding then?

Mr. **Pratt**. Pardon?

Senator **Riegle**. I am not terribly sympathetic with that. What we have got here is the competitive process.

Mr. **Pratt**. That's right. These are not gems.

Senator **Riegle**. Ownership is going to change hands and you have a lot of people showing interest and I want to get the high dollar.

Mr. **Pratt**. I understand that, but you've got to remember that this is a charnel house, that these are cadavers that are being bid for. These are failed institutions and we have a weak industry. Now who's going to bid for them?

Senator **Riegle**. Now wait a minute. I think it may stretch the truth some to make the donation of the thrifty sound quite that black and white. I mean, if they did not have a value, you would not have this traffic jam of people coming through the door to get into the act. The fact is these things have substantial value. I must say I think the discussion you had before about the residual implications for the last group of shareholders, who can range from the principal manager who made the bad decisions which got the thing in trouble to widows and orphans is particularly important. Whatever the residual equity might be is of great value and ought tc be protected.

Mr. Pratt. Senator, let me just answer that.

Senator Riegle. Let me just finish. I want you to answer, but I am concerned that there is a collection of interests here. One is the residual shareholder interest. In other situations, the SEC is empowered under the law to try to look after that side of the puzzle because that is an important consideration. It is not overriding but it is one of a set of considerations. But as I listened to your answer it seemed to show an absence of very strong concern about residual shareholder interest. I would hope that it would not be quite that hard and cold a consideration because whether or not there is any residual equity that might accrue to the remaining shareholders, even if it's 2 cents on the dollar, is an important question. One of the ways to establish that is to get this bidding process out in the open. The fact is that openness counts. That is why we are not having this hearing in a closed meeting somewhere. There is a value in having it open because you get more for them when there are the fullest number of competing interests. I would support that and I would think you would also.

TOP DOLLAR FOR EVERY INSTITUTION

Mr. Pratt. If I might respond, one, we have followed a procedure which we think gets the top dollar and every institution that is assisted by the FSLIC has no residual equity interest. The cases we're talking about are those where the Federal Government has to pay money to solve the problem. That is, the institution is worth less than zero.

Senator Riegle. I'll come back to that in a minute

Mr. Pratt. OK; no person would come in and say, "I'll take the assets and liabilities of this institution and operate it for zero dollars." They'll say, "I want $50 million or I want $100 million to do it." So it's clear that not only is there no residual value, there is a negative value. Under old common law, you will probably remember that bank stock was assessable and you could be asked not only to lose your total assets but to ante up. We've gotten away from that.

Senator Riegle. As you say, there are some questions, when you make a policy determination that the time has come to close an institution. For example, it may or may not be possible for that institution to be sold off to outside buyers some other place without your intervention. That is always a judgment call, is it not?

Mr. Pratt. No; These are institutions that are worth less than zero. We would have been absolutely delighted with any of these institutions had they been sold off to somebody who would have infused capital. It was never a case of that. In fact, most of these large cases go on for a year or year and a half and if at any time during that process somebody would have stepped in and bought it we would have been just thoroughly delighted.

The rug is only pulled when the institution is legally insolvent, in which case no one that has come forward with a voluntary deal has agreed to infuse capital without the U.S. Government infusing capital also; we have never done it in the absence of that.

On the bidding, our goal is to reduce the cost to get the highest possible price and it would be just wonderful if in fact we could not only not have the Government put in money but stockholders would receive some funds. If you would like a private briefing in some depth on these precise procedures, I and I think the Bank Board are perfectly willing to do that—we want to get the highest price. If a change in those procedures would get a higher price, it absolutely should be done and I think disclosure is only a question of what will be the best public policy, what will get the highest possible residual value.

Senator RIEGLE. Just one other question and that is with respect to what I will call third party deals.

Has there ever been a time when you have worked out a deal in with a party making a takeover that it would in the future help solve another problem some other place? In other words, have you ever arranged a 2-for-1 or 3-for-1 deal?

Mr. PRATT. To the best of my knowledge, the Bank Board has never made a deal contingent on something else, and most of the negotiations, of course, never occur at the Board level. It's at the staff level, and I would not be surprised if staff had said, "Well, if you don't get this, there will be other opportunities," or something of that nature. The Bank Board has rolled together two or three institutions, where we couldn't find a solution for one case. That has happened on occasion, but there would never be a promise of future delivery. The Bank Board never enters into an arrangement where the Bank Board commits future action of the Bank Board in terms of what members will vote to do or not to do. Contractually we may agree to perform, but as far as the Bank Board cutting a deal to commit itself to a future vote, that would never occur.

Senator RIEGLE. Well, I would be surprised if it did because such a deal might be illegal.

Mr. PRATT. I would guess that's right, but it doesn't happen.

Senator RIEGLE. What I am concerned about is something that would be less official than that, It would occur more in the vagaries of discussions and understandings where, for example, an outside buyer of some very considerable financial strength might see a great opportunity in a certain hot market. For example different areas of the country have a different appeal in their financial prospects. There may be a very attractive property in a very attractive State or region. There may be two or three others and one other problem in some other part of the country that is not very attractive. You may be a very hard time working out some kind of an arrangement there. Then it just sort of falls into place. Nobody says, "If you do this, I'll do that," but the package sort of gets put together where that party may be favored for the very attractive opportunity and at the same time steps up and swallows a hard pill that you may have some other place. What would be happening is that you would be having a three-way connection. This concerns me because I think each one of these situations ought to have a chance to stand or fall on its own merit and I think there ought to be an active, vital, and open competition for it.

I think anybody who has got the sufficiency to get in and shoulder the property that is available ought to have a chance to do it. I do not think hiding facts enhances the value we are likely to get in the end.

During 17 years in Congress, I have found that the more the facts are out in the open, the better the result in the end. So, I would urge you to think very seriously about getting more of this process out in the open and making sure that more information is available. I think you will find that you are getting a certain high amount of traffic for some of the attractive situations. You are not beating people over the head to come in and look at the attractive situations. They are coming in to look at those. The more vital that competition is, the better. I just repeat again that I think there is a residual shareholder interest here that has to be given some consideration no matter how badly an S&L may have been managed. I think there is a fiduciary requirement with respect to who the shareholders are. If there is any residual equity to be gotten out of this situation, that has to be protected. We have laws in this country to try to look after that.

Mr. PRATT. Senator, we fully agree with that.

Senator RIEGLE. I am wondering whether the SEC should not have the jurisdiction for that side of the puzzle.

Mr. PRATT. First, let me say that we fully agree with that and have aggressively pursued that. We are not talking about institutions with residual shareholder value. We're talking about ones without that. They are obviously companies that are worth less than zero. We do go to the widest possible bidding list subject to the constraints which this body has put on us. I think that it's very interesting that we're talking about subjecting these institutions to a moratorium when there is need for this capital to come in, when I fully agree with you that we should scour the country to find the best possible solution. We try to do that. If we're not doing it as well as we should, then I would like us to improve, but I agree 100 percent with you. This is the money of the people of the United States and shareholders do have legitimate interests if there's a residual value. We should get the highest price and this should be made available to the appropriate parties.

Senator RIEGLE. Have you ever closed an institution that felt it could take and sell itself to an outside buyer and preserve some of its equity. Has there ever been a difference of opinion where you then said, "Sorry, we think we're right and you're wrong. We're closing your doors tomorrow."

Mr. PRATT. Probably, but never one that didn't have an extensive period of time in which it could have done that. Unless you get an institution that performs some very radical act, these institutions generally deteriorate over a period of several years. We did have a case, for instance, where a $100 million institution made a $36 million loan on a project without appraisals and with a 10-minute board meeting. In that kind of case, the institution may go down instantly. But with the great bulk of the problems we see in the savings and loan business, the institution deteriorates over a 2, 3 or 4 year period, and there's an immense amount of time for them to structure any rescue effort that could be done. We start working with them 2 years before it would appear that they're going to be insolvent trying to help them, trying to counsel them, even on bad management, doing anything we can to restructure and help that institution find a private solution.

Senator RIEGLE. Well, if you will indulge me, Mr. Chairman, for 30 seconds more——

The CHAIRMAN. Senator, I will, but you said one more question and that was 10 minutes ago.

Senator RIEGLE. I just want to make sure this answer is clear for the record.

Your statement to the committee is that you have in no cases ever closed an institution that was on the verge of closing a private deal outside where it could have transferred itself into new hands and preserved some of the equity for the shareholders?

Mr. PRATT. That's absolutely correct, assuming that it would have been a legal transfer to someone that could acquire it under the laws and regulations. That's absolutely correct.

Senator RIEGLE. I thank the Chairman.

The CHAIRMAN. Senator Lautenberg.

Senator LAUTENBERG. Very briefly, Mr. Chairman, I'm inclined to agree at times with Mr. Pratt's assessment. Some of these things would not pass the gift test. Nobody would want them because of the continued liability. On the other hand, there is something very important to what Senator Riegle says about shareholders in S&L's and small banks in particular.

New Jersey is not a rural State, but many investors are not sophisticated when it comes to investing in the local bank or the local S&L. They are not aware of the risks involved, Then one day, after 30 years of comfortable dividends, these people who may have a significant share of their assets tied up are suddenly exposed to the fact that they are going to lose them. I would hope that we could make the public more aware of the problem. I don't think it comes in the ultimate salvation of selling for the better price.

Mr. PRATT. Senator, I think the bank regulators, following Senator Riegle's comment, have followed a practice of substantial secrecy. Even though I think disclosure has limited value to depositors, it certainly might have to shareholders.

By the way, for large companies, we adopt the SEC regulations per se. We automatically incorporate all SEC regulations into our law. So for the large publicly traded companies we follow precisely the regulation of the SEC.

Senator LAUTENBERG. I knew that. Let me give you a definition of what I think the S&L or the thrift institutions' responsibility has been. That is, to serve the public. It has not been as much—certainly not in the mutual area—return on investment for shareholders or things of that nature. Does that generally define the mission or the purpose of the S&L?

Mr. PRATT. Well, I think that's subject to a lot of discussion, but that would be a mission that would generally be acceptable to most people.

ANY PROHIBITION HOW CAPITAL IS USED

Senator LAUTENBERG. To serve the borrowers and the depositors. What I'm concerned about with a nonbank acquisition of an S&L is the opportunity to use the capital base in the S&L for divergent purposes, I know of examples where nonbank businesses have taken over S&Ls, and then put much of the bank's resources into a real estate acquisition or something of this nature.

Is there any prohibition in terms of how the capital gets used?

Mr. PRATT. Yes, there are regulations. There are limits on loans to one borrower and all sorts of things of this type.

Senator LAUTENBERG. How about capital?

Mr. PRATT. We do see immense abuses, but those abuses will occur under any system and they are dealt with.

Senator LAUTENBERG. How about capital investments by an S&L particularly? Can an S&L hold real estate on its own in its own portfolio?

Mr. PRATT. I think this is one of the emerging problems and it has to do with the dual State-Federal regulation. As we have moved on the Federal level to give these institutions a better chance to survive, you tend to get movements, say from State charter to Federal charter, and then the State will react and go drastically further. The State of California, for instance, as I recollect, allows very, very heavy direct investments in real estate. That would not be allowed for a federally chartered savings and loan, but these institutions are still federally insured. So, in that sense, in some States, these institutions can be turned to a single purpose, fairly high risk investment vehicle, and I think that's a matter of concern.

Senator LAUTENBERG. Absolutely. Thanks very much, Mr. Pratt. I wish you good luck. I'm sorry that we didn't have a chance to get to know one another better. I know your reputation and I've seen your presentations and they're very good. I'm sure you will enhance the association that you're going to.

Thank you very much, Mr. Chairman.

Mr. PRATT. Thank you, Senator.

The CHAIRMAN. Thank you very much, gentlemen.

May I also say to Senator Lautenberg how much, as chairman, I appreciate freshman Senators. They come to the hearings early and they stay and they ask questions.

Senator LAUTENBERG. I've got no place to go. [Laughter.]

The CHAIRMAN. Well, for whatever reason, you'll notice this with most of the freshman Senators and we appreciate you being here. Thank you very much.

The committee is adjourned.

[Whereupon, at 12:20 p.m., the hearing was adjourned.]

FINANCIAL SERVICES INDUSTRY—OVERSIGHT

Part I

TUESDAY, MAY 3, 1983

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, D. C.

The committee met at 9:30 a.m. in room 538, Dirksen Senate Office Building, Senator Slade Gorton presiding.

Present: Senators Garn, Heinz, Gorton, Hecht, and Lautenberg.

OPENING STATEMENT OF SENATOR GORTON

Senator GORTON. I'll call this meeting to order. I am Senator Gorton. The chairman of the committee, Senator Garn, offers his apologies to the members of the panel. As a member of the majority leadership he was asked to go to the White House for a meeting on the budget which began at 9 this morning. He hopes to return sometime between 10:30 and 11 before you are all completed.

In the meantime, however, Senator Hecht and I and any other member who comes will be delighted to hear the testimony of this distinguished panel of commercial bankers.

In reflecting on this ongoing series of hearings, we've seen during the course of just the last few years an onrush of deregulation and a blurring of distinctions among various kinds of financial institutions, the emergence of nonbank banks, and a significant number of bank failures or forced mergers, 42 in number in the year 1982.

Last year, as all of you on the panel and in the audience know, the Congress took extremely significant action with the passage of the Garn-St Germain bill. It's interesting however that it seems to be changing far more rapidly than our ability and that of the regulatory agencies to keep up.

The purpose of this series of hearings is to continue the committee's oversight of the financial services industry and to establish what kind of new regulation, if any, may be required to provide the facilities for the best possible banking and other financial servicing for citizens and business community of the United States.

With that, what I believe that we will do is to proceed to hear the formal testimony of each of you who has joined with us here today. Please understand that your entire written statements will be included in the record as if read. Unless they are relatively short, we would appreciate your summarizing them. With that, we will start with Mr. Kennedy.

STATEMENT OF WILLIAM H. KENNEDY, JR., CHAIRMAN OF THE BOARD, NATIONAL BANK OF COMMERCE, PINE BLUFF, ARK.; PRESIDENT, AMERICAN BANKERS ASSOCIATION

Mr. KENNEDY. Thank you, Mr. Chairman. Members of the committee, I'm William H. Kennedy, Jr., Chairman of the board of the National Bank of Commerce, Pine Bluff, Ark., and president of the American Bankers Association.

[Complete statement follows:]

STATEMENT OF WILLIAM H. KENNEDY, JR., ON BEHALF OF THE AMERICAN BANKERS ASSOCIATION

Mr. Chairman and members of the Committee, I am William H. Kennedy, Jr., Chairman of the Board of the National Bank of Commerce, Pine Bluff, Arkansas, and President of the American Bankers Association. The combined assets of our nearly 13,000 member banks represent approximately 95 percent of the industry total. While our members range in size from the smallest to the largest banks, approximately 90 percent of them have assets of less than $100 million.

At the outset, I would like to commend the Chairman for calling these hearings to undertake a thorough review of the statutory and regulatory framework in which the financial industry operates. These periodic reviews are necessary to assess the need for changes in law to insure that financial institutions are able to efficiently meet the needs of their customers. One example of the value of the legislative review process is the greatly enhanced ability of depository institutions to meet their customers' needs resulting from the Garn-St Germain Depository Institutions Act of 1982. That legislation grew out of an earlier review of the laws affecting financial institutions undertaken by this Committee under the Chairman's guidance.

Among other things, the Garn-St Germain Act put the deregulation of deposit interest rate ceilings back on track. That process had begun with the Depository Institutions Deregulation and Monetary Control Act of 1980 but was largely stalled until the 1982 legislation. The tremendous popularity of the two new accounts created following the 1982 legislation is testimony to the foresight of this Committee in allowing financial institutions to meet their customers' needs. We would like to focus today on the next step in allowing commercial banks to meet their customers' needs—expansion of the products and services that banks are allowed to offer.

Our own review of the statutory and regulatory framework in which financial institutions operate is based on the four criteria that have been adopted by our Government Relations Council and are used by that Council to evaluate policy positions. They are:

(1) How do bank customers benefit from the proposal?

(2) Will the proposal enhance the broad competitive environment? If the proposal is not procompetitive, is it otherwise demonstrably necessary to achieve the objective of maintaining the safety and solvency of financial institutions?

(3) Is the proposal consistent with national economic and social priorities?

(4) Does the proposal provide the opportunity for competitive financial institutions to maintain viability and profitability regardless of size? Does the proposal achieve or maintain equal competitive ground rules among the various types of competing financial institutions?

We believe that an expansion in the products and services that banks can provide is essential to allow banks to serve their customers, our first criterion. As we describe in some detail below, bank customers are demanding financial services which banks cannot provide under current law. As a result, these customers are looking to other providers for these services.

Much of the discussion about how to allow banks to offer new products and services has centered around the Bank Holding Company Deregulation Act (S. 2490) introduced last year at the request of the Treasury. Four basic principles underlie the Treasury proposal: (1) The products and services that can be offered by commercial banks should be expanded; (2) The process for gaining regulatory approval for banks entering many of the permitted service areas should be simplified; (3) The same regulatory restrictions should be imposed on all firms supplying the same service, sometimes referred to as functional regulation; (4) All new financial services should be segregated in a subsidiary of a bank holding company. The legislation would allow an exception to the last principle for securities services in banks below a certain size.

We believe that conceptually these basic principles meet our four criteria. In particular, the expansion of bank services and the simplified process of regulatory approval for banks entering approved areas will benefit consumers and enhance the competitive environment—our first two criteria. The principle of functional regulation will enhance the competitive environment by insuring that all financial institutions compete under the same rules, our fourth criterion. The Treasury proposal expands bank services in a way that allows preservation of the safety and soundness of our banking system, a major economic policy goal. Much of our third criterion is achieved by placing the new services in subsidiaries of bank holding companies, thus insulating the bank from any possible increase in risk associated with these new activities. While we believe that it is also possible to preserve the safety and soundness of our banking system if these new services are offered through subsidiaries of the bank or through a service corporation, the Treasury approach of separation is certainly one way to preserve the safety and soundness of the banking system and is consistent with the manner in which the larger banking organizations are choosing to operate. The Treasury proposal contains a so-called exemption for small banks which allows them to segregate these securities activities into a service corporation subsidiary of the bank rather than a separate subsidiary of the holding company. This will ensure that banks of all sizes have the opportunity to maintain viability and profitability in the securities area, thus meeting our fourth criterion. For reasons described below, we believe this exemption should be extended to somewhat larger banks and should include all of the new activities to be authorized.

The product restrictions addressed in the Treasury proposal represent only one of the major categories of regulation imposed on financial institutions. In addition, restrictions limit the price banks can charge for products and services and the price they can pay for deposits. Procedure restrictions regulate the way in which banks can produce and offer products and services. Place restrictions regulate the geographic areas in which the goods and services can be offered. Together these may be referred to as the four P's of deregulation—product, price, procedure, and place. In addition to the changes in product restrictions discussed above, we believe significant changes are needed in the price and procedure restrictions. I will discuss each of these in more detail. First, I will briefly review the changes in the economic and financial environment that we believe necessitate these regulatory changes.

Economic and financial environment

A large number of the restrictions currently imposed on commercial banks date from our experience during the Great Depression of the early 1930's. These restrictions represent an attempt to meet the demands for financial services in an environment conditioned by a significant decline in the money supply which led to rapid deflation, a large number of financial institution failures, and a very high level of unemployment. The environment today is much different and has changed the financial needs of both consumers and businesses.

In place of rapid deflation and its attendant challenges, we now have a history of inflation that has brought a whole new set of problems. During the 1970's the rate of inflation reached levels that were uprecedented during peacetime. The seeming inability of the Federal government to control inflation has created great uncertainty about the future. At this time, it is still uncertain whether the recent decline in inflation has brought with it a return of investor confidence in the government's ability to control inflation.

A related development in the financial environment is the increase in interest rate volatility which has increased the demend for short-term assets relative to long-term assets. Volatility in interest rates also creates a tremendous problem for those financial intermediaries having a mismatch between the maturity of their assets and liabilities. Allowing financial institutions to offer a full range of diversified financial services may make them less vulnerable to the risks associated with interest rate volatility.

Finally, there has been an important demographic shift in the country that affects the demand for financial services. Specifically, the people who were born during the post-World War II baby boom have now come of age and are in the process of acquiring housing and other consumer durable goods. This age group has become increasingly concerned about securing adequate income during their retirement years as uncertainty about the future has increased due to inflation and declining confidence in the Social Security System.

These changes in the financial and economic environment have altered the financial service needs of both consumers and businesses. Just as importantly, the ability of financial institutions to meet these needs has been enhanced as a result of revolutionary changes in technology, particularly the technology used in communication and data processing. New technology may mean that it is now cheaper for a single firm to produce two different types of financial services together than for two individual firms to produce them separately. Allowing firms to utilize any of these economies of joint production and distribution may result in lower cost and greater convenience for customers.

Advances in communications have also had an impact in the financial environment. More and more, communities across the country have been knit together into national money and capital markets, facilitating the flow of funds from communities with a surplus of funds to communities with a shortage of funds. As a result, residents of even the smallest rural communities now have opportunities to invest in assets that earn interest rates determined in nationwide money and capital markets.

Having described the environmental changes, let me now describe in some detail the legislative changes we feel are necessary for commercial banks to meet their customers' needs in this new environment.

PRODUCT RESTRICTIONS

One of the highest priorities of the American Bankers Association is to liberalize the Federal laws and regulations which restrict the products and services that commercial banks can offer. Federal law and regulation have made it increasingly difficult for banks to meet their customers' financial needs in the economic environment described above. As a result, bank customers have turned to other financial institutions. Almost weekly there are new examples of financial institutions offering a new service to fill a gap created by the constraints on commercial banks. Let me give you a few examples.

An increasing number of financial institutions have found ways to offer products and services that are close substitutes for those offered by commercial banks. For example, securities firms, life insurance companies, and even retailers have offered money market funds or cash management accounts that have drawn a significant volume of funds from depository institutions. In many cases, these shifts of funds resulted from the inability of commerical banks to offer a market interest rate. In other cases, they resulted from the inability of banks to offer a full line of financial services.

A growing number of differently regulated financial firms are gaining the ability to offer a broader range of financial services by establishing or acquiring commerical banks or thrift institutions. For example, the Dreyfus Corporation, a large mutual fund organization, has purchased the Lincoln State Bank of East Orange, New Jersey. It also has received a charter from the Comptroller of the Currency for the Dreyfus National Bank and Trust Co. in New York and has an application pending with the Federal Home Loan Bank Board to acquire the Metropolitan Savings and Loan Association in Arlington, Virginia. Thomson McKinnon, Inc., a New York-based securities firm which owns the nation's third largest realty franchise, has signed an agreement to acquire First Federal Savings and Loan of Madison, Connecticut. A subsidiary of the Prudential Insurance Company has signed an agreement to buy the Capital City Bank of Hapeville, Georgia in order to offer Federally insured accounts to its customers. Prudential also owns Bache and Co., a large securities firm. The Travelers Insurance Company has requested regulatory approval to offer an FDIC-insured instrument to its customers through a trust subsidiary. Only last week the J.C. Penney Co. announced that it has agreed to acquire First National Bank of Harrington in Delaware to provide its customers with consumer financial services. In some cases, these acquisitions have been actively encouraged by the regulatory agencies. For example, the Federal Home Loan Bank Board reportedly solicited bids from several securities firms for the troubled Suburban Savings and Loan Association in New Jersey (American Banker, April 1, 1982, p. 1).

The acquisitions or formations of savings and loan associations by non-deposit institutions are possible because there are no restrictions on holding companies that own a single savings and loan association. The acquisitions or formations of banks are possible because of a provision of the Bank Holding Company Act which defines a commercial bank as an institution which both offers demand deposits and makes commercial loans. Thus, these institutions have received regulatory approval for their acquisitions by selling off the commercial loans. Presumably, a so-called "non-bank" institution could offer its customers both commercial loans and demand deposits through two separate limited bank subsidiaries.

Recently, the Comptroller of the Currency announced a moratorium on the chartering of such limited-purpose banks. We believe that such a moratorium wili be of little value, of dubious legality, and should not have been implemented. "Non-bank" firms will simply turn to other ways of offering banking services to their customers such as acquiring national banks, state banks, or thrift institutions or chartering state banks or thrift institutions. The growing number of such acquisitions or charters shows the existence of customer demand for a broader range of financial services from a single supplier. We believe the apppropriate response to the problems we are discussing is for Congress to authorize all financial institutions to offer the broad range of financial services that their customers demand.

The financial service centers being installed in a number of Sears retail outlets provide one examle of a non-depository institution's ability to offer a broad range of financial services. Suppose that while shopping at Sears for automobile tires some Saturday afternoon, you decide to take care of some of your financial affairs. If you have surplus funds to invest, just step over to the Dean Witter Reynolds counter to purchase shares in a money market fund on which you can write checks (in a minimum amount of $500). You could also purchase a newly issued security or any other security including one in which Dean Witter Reynolds makes a market. Alternatively, you can open a cash management type account with $20,000 in either cash or securities. Such accounts allow you to tranfer money between short-term liquid money funds and other investments and to write an unlimited number of checks. With $20,000 of securities in the account, you can borrow up to $10,000. If it's an auto loan you need, just step around to the Allstate counter. If its a mortgage loan you need, that's one counter down at the Coldwell-Banker sign. The real estate agent there will also help you find and acquire that new home. If you need insurance for your home, car, boat, life, or health, kindly step back to the Allstate counter. Finally, if you need to underwrite a few stocks or bonds to finance your company's expansion, the Dean Witter Reynolds representative would probably be glad to call company headquarters to accomodate you. In addition to these financial services subsidiaries, Sears also owns a large savings and loan association and a private mortgage insurance company.

Some non-bank depository institutions are finding ways to meet their customers' demands for a broader range of financial services within the current regulatory environment. Savings and loan association service corporations have the authority to make real estate equity investments. This allows them to provide alternative sources for real estate financing which banks cannot offer. Service corporations owned by Federal savings and loan associations have also been able to offer life insurance since 1970. It should be noted that although there is legislative history that indicates congressional desire to limit such activities to be consistent with the Home Owners Loan Act, the Federal Home Loan Bank Board could still authorize a wide range of activities through these service corporations. Finally, savings and loan associations have moved to utilize the commercial and consumer lending powers granted to them in recent years.

On the other hand, commercial banks have only been able to slightly expand the range of services they offer primarily through the use of subsidiaries of the bank or a holding company. For example, they can now own a Futures Commission Merchant subsidiary. However, for the most part the range of services that commercial banks can offer through subsidiaries of a bank holding company is extremently limited and most of these services can be offered through the bank as well as the holding company. For example, commercial banks or bank holding companies have always been able to offer insurance that is related to credit services such as credit life insurance. However, only banks in very small communities can offer a full range of insurance products. Likewise, bank holding companies only recently gained regulatory approval to offer discount brokerage services that are limited to the execution of buy and sell orders. They cannot offer a full-line of securities brokerage services that includes dealer activities and making markets. In addition, discount brokerage doesn't represent an expansion of bank services, since national banks have always had the authority to provide this service.

In some cases, marketplace developments in the provision of diversified financial services have been spurred by changes in state laws. The most recent example of this is the enactment of a law in South Dakota to allow state banks to own full-line insurance companies. Already several out-of-state bank holding companies have shown an interest in acquiring or forming a South Dakota bank. In the last year, current several sessions of state legislatures have shown significant interest in liberalized bank regulations in order to allow forms of interstate banking to facilitate economic development.

Study of expanded bank services

The inability of commercial banks to meet their customers' demands for a broad range of financial services has stimulated them to search for opportunities to expand the products and services they offer. There is a second force pushing banks in the same direction. The deregulation of deposit interest rate ceilings is increasing the relative cost of funds at commercial banks and may reduce net interest margins. Thus, many commercial banks have begun of necessity to look at additional products and services as a potential source of service charge and fee income to offset the possible decline in interest rate margins.

To help our members in this process, the ABA last year contracted with Arthur Young and Co. to evaluate the feasibility of commercial bank entry into 13 financial service areas. These included: securities brokerage, securities underwriting, mutual funds, commodities/financial futures brokerage, insurance brokerage, insurance underwriting, real estate brokerage, real estate equity, travel agency, telecommunications, data processing, non-full payout leasing, and management counsulting. Although some banks and bank holding companies now provide some of these services, there are some statutory or regulatory limits on the ability of commercial banks to offer fully each of the services.

Arthur Young and Co. evaluated each of these 13 service areas using two separate criteria. First, how attractive is the service market for any potential entrant? Second, how well are banks postitioned to enter the service markets? To evaluate service market attractiveness, the consultants examined such things as the return on equity, the rate of market growth, and the extent of barriers to entry. To evaluate the resources available to commercial banks to enter these service markets, the study examined such things as the overlap in customer base, and the skills or expertise available to commercial banks. The study recognizes that different sizes of banks might have different resources available with which to enter new service markets. Thus, the availability of resources needed to enter each service market was analyzed for three different sizes of banks—large money center banks, medium size banks, and community banks.

The consultants found two service markets which they ranked high both in terms of bank positioning and industry attractiveness for all three sizes of banks. These were real estate equity and insurance brokerage. Discount securities brokerage, which banks can already offer, also ranked high on both criteria for all sizes of banks. In addition, full service securities brokerage was ranked high both in terms of industry attractiveness and bank positioning for the mid-sized and large banks. The project summary of the results of the Arthur Young Study is attached as Appendix A of this testimony. A supply of the entire 600 page study is available to the Committee staff.

The Arthur Young Study is designed to help banks evaluate which additional products or services would help them better meet their customers financial needs. The conclusions of the study are meant to apply to broad industry groups and are only a guide to individual banks who must necessarily make their own market decisions. Provision of many of these additional services must in most cases await specific legislative changes, which I will now address.

Proposed Bank Holding Company Deregulation Act of 1982 (S. 2490)

As you recall, four principles underlie the Treasury proposal: (1) The products and services that can be offered by commercial banks should be expanded. (2) The process for gaining regulatory approval of banks entering many of the permitted service areas should be simplified. (3) The same regulatory restrictions should be imposed on all firms supplying the same service. (4) All new activities should be segregated in a subsidiary of a bank holding company. The legislation would allow an exception to this principle for securities services in banks below a certain size.

1. Expanded services.—The Treasury proposal would enable commercial banks to undertake a number of specific activities from which they are currently prohibited. These include insurance brokerage and underwriting, real estate investments, real estate development and brokerage, underwriting state and local revenue bonds (except industrial development bonds), and mutual fund services. In addition, the proposal directs the Federal Reserve to expand the list of products and services that commercial banks may offer to include any business of a financial nature. This would undoubtedly allow commercial banks to offer a broader range of products and services than they are currently permitted to offer.

We wholeheartedly support the principle of expanded services for commercial banks. We also believe that the Federal Reserve should have discretion to expand the list of allowable activities. This is necessary to ensure that commercial banks will be able to offer financial products and services to meet the needs of their customers as they evolve in the future. Therefore, we believe that any legislation should indicate Congressional intent that the list of additional activities should include a broad range of financial services.

It should be noted that the Treasury proposal not only allows commercial banks to offer additional services, it also allows non-deposit institutions serving these markets to offer banking services by establishing or purchasing a commercial bank so long as they offer only the services that a bank holding company can offer.

2. Simplified regulatory approval.—The Treasury proposal simplifies the process for obtaining regulatory approval to enter many of the approved lines of business. In those lines of business that the legislation specifically authorizes, banks may enter without prenotifying or gaining the approval of the Federal Reserve. For any other lines of business which the Federal Reserve designates as being of a financial nature, banks may enter after a 60 day prenotification period which may be extended another 30 days by the Federal Reserve. Providing the bank meets the requirements for entry imposed on non-bank firms, this could greatly increase the speed with which commercial banks can enter attractive market areas, and reduce the bank regulatory cost of such entry.

We support the principle of simplified procedures for regulatory approval of banks offering new services. Currently, bank holding company entry into a new service area is often delayed and legal costs become excessive because of the complicated process for securing regulatory approval. One particularly burdensome problem is the manner in which competitors of banking organizations have used the public notification and hearing process to delay bank expansion, protect their own markets, and stifle competition to the detriment of customers of financial institutions.

We also believe that an attempt should be made to reduce the time and expense of forming a bank holding company. It is not unusual for a holding company formation to take a year to consummate and cost in excess of $50,000 even where the resulting holding company will be held by the very same shareholders as the bank. This excessive cost and delay could limit the ability of banks to provide these new services to their customers.

3. Same regulations applied to all firms.—The Treaury proposal would subject all firms performing the same function to the same regulations imposed by the same regulatory agency. For example, the securities activities of subsidiaries of a bank or a bank holding company would be regulated by the Securities and Exchange Commission. We support the principle of functional regulation and believe it will provide a level playing field for all institutions providing the same types of financial services. This principle will ensure that those institutions that fare well in the marketplace do so because they most efficiently meet the needs of their customers, not because of advantages granted by a regulatory body.

While functional regulation would provide competitive equity among banks and non-bank institutions, it should be noted that there would continue to be regulatory disparities between banks and savings and loan associations. For example, some savings and loan associations could continue to provide a broader range of services because there are no limitations on the activities of a holding company which owns only a single savings and loan association. In addition, they would continue to have substantially different regulatory treatment.

4. Segregation of non-bank activities.—The Treasury proposal segregates new activities to the subsidiaries of bank holding companies. Further, if a bank were to offer any of the additional securities services authorized in the proposal, all of the bank's current securities operations would have to be based in the securities subsidiary of the holding company. A bank could continue to underwrite municipal general obligation bonds and Treasury securities within the bank only if it did not utilize any of the expanded securities powers offered in this legislation. An exception to this segregation rule is provided for those banks with total assets of less than $100 million. These banks would have the option of offering securities services in either a subsidiary of the bank or the holding company. In either case, these securities activities would be regulated by the Securities and Exchange Commission. This exception is designed to prevent the excessive cost and delays attendant with the formation of a holding company that might limit the ability of smaller commercial banks to meet their customers' financial needs.

We believe that segregation of new activities is an approach to ensuring the safety and soundness of the banking system while allowing banks to meet their customers demands for a broader range of financial services. It has been suggested that some of the new services demanded by bank customers may involve greater risk than do traditional banking services. Segregation of these new activities in a separate affiliate along with the authority of the regulatory agencies to examine and supervise the transactions between the bank and its affiliates would help to ensure that any increased risk does not affect the bank.

There is a fundamental principle of corporate law that a corporation is a legal entity distinct and separate from its shareholders even when the only shareholder is another corporation. Courts have been willing to pierce this corporate veil only under very limited conditions. Thus, if an affiliate offering new services experiences financial difficulties, it will not affect the financial condition of a related bank under the Treasury proposal. Moreover, the ability to examine and supervise the transactions between the bank and its affiliate would give the regulatory agencies the ability to prevent the bank from transferring its financial resources to support a related company.

The principle of corporate separateness provides one other advantage. It allows the bank regulatory agencies to preserve the safety and soundness of the bank without having to regulate the activities of the non-bank subsidiaries, an area where the bank regulator is likely to have less expertise.

While the principle of corporate separateness will preserve the safety and soundness of the banking system, it may also involve substantial costs and prevent financial firms from achieving some of the advantages of offering diversified financial services. We are especially concerned that the need to create a holding company would increase the cost to smaller institutions of providing these new services, thus limiting the opportunity of these institutions to serve the needs of their customers. For these reasons, we encourage a study of alternative approaches to preserving the safety and soundness of the bank other than the bank holding company separate principle. However, if the corporate separateness approach is adopted, we believe that banks with assets up to $250 million should be able to offer all of the new services, not just securities services, through a subsidiary of either the bank or the holding company.

PRICE RESTRICTIONS

Three years ago price restrictions were the major impediment to depository institutions serving the needs of their customers. During the late 1970's and early 1980's market interest rates soared above the deposit interest rate ceilings imposed on depository institutions. Because banks could not meet their customers' demands for a highly liquid market rate deposit instrument, a significant volume of funds flowed out of deposits into other financial instruments. For example, the rapid growth of money market funds is testimony to their ability to meet the savings needs of the public. The resulting shift of funds from depository institutions to money market funds weakened the ability of small and medium sized banks to meet the credit needs of their local communities. In addition, the shifting of funds made it more difficult to interpret the monetary aggregates which further complicated the conduct of monetary policy.

Congress recognized these problems, and in 1980 passed the Depository Institutions Deregulation and Monetary Control Act. That Act created the Depository Institutions Deregulation Committee (DIDC) with a directive to phase out all deposit interest rate ceilings by 1986. In the early years of its existance, the DIDC focused primarily on eliminating the ceilings on longer term time deposits. Although the Committee created some shorter term deposits paying market oriented interest rates, these instruments did not stem the flow of funds from depository institutions to non-deposit instruments.

In response, Congress passed the Garn-St Germain Depository Institutions Act of 1982 which directed the DIDC to authorize a new account that would be "directly equivalent to and competitive with money market mutual funds." The result was the money market deposit account (MMDA) authorized in December of 1982. The DIDC quickly followed the MMDA with authorization of the Super Now account in January 1983. These accounts have been tremendously successful. For the week ending April 13, Money Market Deposit Accounts averaged $340.2 billion and the Super NOW account averaged $29.1 billion. The decline in money market funds from $240 billion to below $190 billion during this period suggests that a significant volume of funds in the new instruments probably came from the money market funds.

As a result of congressional action in the Garn-St Germain Depository Institutions Act and the DIDC's response to that Act, depository institutions now have an instrument that is fully competitive with money market funds. In addition, we believe that the DIDC has established a reasonable phase out schedule for the remaining interest rate ceilings on time and savings deposits. Under the current schedule, interest rate ceilings on time deposits of 2½ years maturity or more were eliminated on April 1st of this year. The interest rate ceilings on time deposits with maturity of 1½ years to 2½ years are now tied to market interest rates on comparable maturity

Treasury securities. Next year the interest rate ceilings on these 1½ year maturity instruments will be completely eliminated. In 1985, all interest rate ceilings on time deposits with a maturity greater than six months will be completely eliminated. In 1986, interest rate ceilings on all time and savings deposits will be eliminated.

The DIDC will consider two additional proposals at its meeting in June. These are an acceleration of the schedule to phase-out interest rate ceilings and the removal of the limitations on the number of checks written on the money market deposit account. The ABA is in the process of surveying a sample of our members to determine the likely impact of eliminating the transactions limitation on money market deposit accounts vis-a-vis a general lifting of the prohibition of interest on demand deposits. Both this issue and the proposed accelerated phase out of interest rate ceilings will be considered at the next meeting of the Administrative Committee of our Government Relations Council.

The need for usury relief

Although the Congress and the DIDC deserve congratulations for the work they have done in eliminating price restraints on deposits, the task will not be complete until price restrictions on the asset side of the balance sheets of depository institutions are also removed. In an attempt to provide the asset flexibility needed to adjust to the elimination of deposit interest rate ceilings, the Depository Institutions Deregulation and Monetary Control Act of 1980 provided a three year Federal override of state usury laws on business and agricultural loans. A permanent override on first mortgage loans was also included subject to the right of the states to reinstate within three years. No comparable override was provided for consumer loans. The three year Federal override on business and agricultural loans expired on April 1st of this year. Although some states have eliminated or liberalized their usury ceilings since the passage of the Monetary Control Act, the continued existence of usury ceilings in some states could endanger the adjustment of depository insitutions to an environment free of deposit interest rate ceilings. Senators Garn, Lugar and Proxmire have recently introduced a bill (S. 730) to eliminate all usury ceilings on all types of credit, while maintaining state enacted consumer protection provisions. Our Association believes this proposed legislation would give depository institutions the flexibility on the asset side necessary to survive in the new deregulated environment.

Not only are usury ceilings a problem for depository institutions, they are also detrimental to bank customers. In fact, study after study has shown that usury ceilings consistently harm the very people they are intended to help. The following are among the harmful effects on consumers found in empirical studies:

Rate ceilings cause lenders to ration credit by lending to only the lowest risk customers.

Prices of goods and services are higher in states with restrictive lending rate ceilings.

Usury ceilings force some consumers to acquire more costly credit elsewhere.

Lenders in low rate states tend to eliminate smaller, short-term loans.

A bibliography listing some of the major studies of the effects of usury ceilings is attached as Appendix B.

We urge immediate passage of S. 730, The Credit Deregulation and Availability Act of 1983, sponsored by Chairman Garn and Senators Lugar and Proxmire.

The impact of reserve requirements

Non-interest bearing reserve requirements are another impediment which may prevent depository institutions from making full use of their new freedom from deposit interest rate ceilings. Depository institutions are currently required to hold reserve balances equal to a certain percentage of their transactions and non-personal time deposits. These reserves may be held either in the form of vault cash or deposits at the Federal Reserve. No interest is earned on the balances held at the Federal Reserve. This reduces the interest income of depository institutions and lowers the rate they can afford to pay on deposits. Since most of the profits of the Federal Reserve are paid to the Treasury, failure to pay interest on reserve balances held at the Federal Reserve has the same effect as a tax on depository institutions, and indirectly, the customers who purchase financial services from them.

We believe that reserve requirements are an important tool for implementing monetary policy. However, the failure to pay interest on these reserve balances actually hinders the implementation of monetary policy by providing an incentive to devise new financial instruments that are close substitutes for reservable deposits. One such innovation is the money market fund. Shifts of funds between reservable deposit instruments and non-reservable deposit substitutes complicates the Federal

Reserve's implementation of monetary policy. In recent years, we relied heavily on monetary policy to reduce inflation. The job of formulating and implementing an effective monetary policy would be facilitated by payment of a market rate of interest on reserve balances held by depository institutions at the Federal Reserve.

At one time the implicit tax on non-interest bearing reserves was justified on the grounds that the institutions subject to this tax received free services from the Federal Reserve. However, since the Federal Reserve has begun explicitly pricing its services, this justification no longer exists.

RESTRICTIONS ON PROCEDURE

A significant amount of regulation deals with how banks may conduct their business. Our discussion of regulation of bank procedure falls into three broad areas: regulations imposed on banks in connection with the deposit insurance system; the structure of the regulatory agencies; and the growing number of regulations intended to protect the consumer.

Deposit insurance

The legislative response to the banking and financial crises of the 1930's created much of the regulatory framework within which the banking industry still functions. The Banking Acts of 1933-35 were designed to promote safety and soundness in banking. The legislation took two approaches. First, regulatory restrictions were imposed. The most significant of these were price controls in the form of deposit rate ceilings on time and savings deposits and the prohibition of interest on demand deposits, and the attempt to separate commercial banking and investment banking. Second, the Banking Acts of 1933-35 created the federal deposit insurance system, which was designed to protect the small depositor from loss due to bank failure and to facilitiate trade and commerce by promoting a stable financial system.

In 1982, the Gar-St Germain Depository Intitutions Act requested that the federal deposit insurance agencies conduct a broad based study evaluating the impact and performance of the current deposit insurance system and examining several avenues of possible change. We appointed a Task Force which has met with the FDIC on several occasions and had made recommendations. We would like to share some of their thoughts with you.

The federal deposit insurance system has functioned extremely well over the past fifty years. Changing economic and social conditions in conjunction with tremendous strides in technology over the past half century have, of course, forced changes in industry structure and regulation. The banking industry of the 1980's is of necessity drastically different from that which existed in the 1930's. It is certainly in the best interests of the three paries involved—the public, the banks, and the government—to look carefully at the current system of federal deposit insurance and to see whether it may be improved to better fit the needs of each.

The Task Force urges caution, however, that any reform not merely trade any perceived shortcomings of the current deposit insurance system for a different set of problems. The FDIC is proposing significant changes in the system, including introducing a shared risk concept, increasing the type and amount of data disclosed by banks, and basing effective insurance premiums on risk. Each of these proposals has advantages and disadvantages. We believe it is important not only to evaluate the relative merits of alternative systems, but also to ask whether the alternative is an improvement over the current system. The position of ABA's Task Force is attached to this testimony as Appendix C. We would like to add that this report is a working document which will be considered in coming meetings of our Government Relations Council.

While we are not prepared at this time to discuss the details of FDIC's proposals for reform of the deposit insurance system, we would like to comment briefly on the overall thrust of its approach. Essentially, the FDIC seeks to increase market discipline through risk sharing with large depositors, and through an increase in the data made available to the public. This represents a basic change in existing regulatory practice. Traditionally, bank depositors have been protected by a process of examination and supervision which has been at least partially aimed at preventing excessive risk taking. The SEC, on the other hand, seeks to protect investors by requiring disclosure of various types of information and letting investors choose their own level of risk. The FDIC's proposals would thus seem to more closely parallel the SEC philosophy than traditional bank regulatory practice. While we do not object in principle to the concept of greater risk sharing with large depositors and uninsured creditors, we are not convinced that significantly increased mandatory disclosure of bank operating data is necessary or desirable. A great deal of bank data are currently available to depositors but are not used. If there is a change in legislation which increases the perceived risk of some bank customers, the available data are likely to be used more intensively. Before requiring banks to disclose significantly more data, we believe that its potential usefulness in protecting the banking public should be more carefully analyzed.

Financial Institutions Regulatory Act

In 1978, Congress passed the Financial Institutions Regulatory Act (FIRA). That legislation set limits on a bank's ability to deal with its directors, officers and employees in certain credit related areas. The intent was to protect the deposit insurance fund by promoting the safety and soundness of the banking industry. In fact, many of these restrictions do little but limit the ability of banks to serve their customers. Because the burdens imposed on bank management are out of all proportion to the purposes of the Act, a number of modifications are being sought by our Association to correct the inequities. The federal banking agencies have endorsed many of these amendments, and we commend this Committee for its efforts to pass them last year. Although all the amendments did not survive the House-Senate Conference Committee, we strongly endorse continued efforts to liberalize this onerous law. An outline of our proposals is attached to this testimony as Appendix D.

FIRA also placed restrictions in the electronic payments area that limit the ability of banks to serve their customer's financial needs. Our Association advocates legislation which would reduce the compliance burdens imposed by the Electronic Funds Transfer Act, enabling banks to offer more efficient and less costly EFT services to consumers without sacrificing significant consumer protection. We have attached a detailed discussion of these issues as Appendix E.

Regulatory structure

In the fall of 1982, Vice President Bush designated a Task Group on Regulation of Financial Services. ABA was asked to submit it views on the streamlining of the federal financial regulatory process. In February 1983, we appointed an ABA Task Force on Restructuring the Federal Financial Regulatory Agencies. This Task Force has drawn up a list of criteria for judging proposals to change the regulatory system for financial institutions. A copy of the list of criteria including a brief description is attached as Appendix F. We would again note that this is the work of a banker task force which will be considered by our Government Relations Council in its coming meeting and through the course of the deliberation of the Bush Task Force.

Consumer protection legislation

During the late 1960's and the 1970's, several statutes were enacted to achieve certain social goals Congress felt would not be achieved by the marketplace. While most of these laws have laudable objectives, in practice many have achieved little except to reduce bank efficiency and productivity.

The most urgent need for reform is in the Bankruptcy Reform Act of 1978. From 1978 to 1982, the number of individual bankruptcies jumped from 172,423 to 449,839—an increase of 160 percent. While we recognize that economic conditions during this period have caused many bankruptcies, we believe that the liberal provisions of this law can blamed for much of the increase.

The actions of the Senate last week, if adopted by the House, will go a long way towards alleviating these problems.

The Home Mortagage Disclosure Act and the Community Reinvestment Act are two pieces of legislation whose costs demonstrably exceed their benefits. The Home Mortgage Disclosure Act requires financial institutions to disclose publicly the number and location of their residential mortgage loans. Overall, bankers report very infrequent requests for these data.

The Community Reinvestment Act (CRA) requires that bank regulatory agencies (1) assess a financial institution's record of meeting its community's credit needs, and (2) take that assessment into account when making chartering, branching, and other corporate structure decisions. Regulations under the Act require banks to draw maps of their communities, draft lists of the types of credit they will make available therein, and post a public notice about the availability of this "CRA statement" and the opportunity for their customers to comment thereon. CRA requires banks to document their efforts to accomplish what they must already do to remain competitive and profitable—namely, to serve their communities. In addition, it appears that virtually no bank customers ever request copies of most banks' CRA statements.

It is our Association's strong belief that these two Acts should be repealed. They are prime contributors to a feeling among bankers of the irrelevance of many laws and regulations.

Bankers also continue to express concern over the compliance burdens and the risk of law suits under the Truth in Lending law as simplified in 1980. We do not need or desire another major simplification. However, there are changes that should be implemented which would substantially reduce compliance burdens without requiring creditors to undergo costly procedural change. We urge the Committee to act on these as quickly as possible. Also, there are two significant provisions of the 1980 law which will soon expire, and need to be made permanent. Appendix G details what we believe are the needed changes to Truth in Lending.

RESTRICTIONS ON PLACE

Historically, banking in the U.S. has been characterized by many banks serving local communities. As branching became more common around the turn of the century, it was generally accepted that a bank could go only where it was authorized by state authorities. In 1911, the U.S. Attorney General ruled that national banks could not branch at all even within state or local boundaries. National banks, unable to compete with state banks where branching was permitted, pressured Congress for legislation overturning the Attorney General's ruling. The resulting McFadden Act of 1927, and the amendments to it that were part of the Banking Act of 1933, allowed national banks to establish branches in those states where state chartered banks had the same authority. The Douglas Amendment to the Bank Holding Company Act of 1956 prohibited a bank holding company from acquiring a bank outside of its home state unless the state specifically permits such acquisitions. Thus, historically, the geographic distribution of banks has been governed by state authorities rather than the Federal government. It has been the long standing position of the American Bankers Association to support the concept embodied in the McFadden Act and the Douglas Amendment. Although our Association's policymaking bodies have not recently engaged in a debate of geographic limitations on banks, I believe that most bankers would probably continue to believe that intrastate branching and interstate bank holding company acquisitions should continue to be controlled by the individual states.

Recently, the effectiveness of the geographic restrictions on the provision of bank services has been significantly eroded. For example, a special study conducted by Peter Merrill Associates for ABA in January 1981 concluded that despite restrictions, provision of bank and bank-like products and services on an interstate basis is widespread.

Interstate acquisitions of troubled thrifts by sound thrifts and banks over the past two years are perhaps the most publicized cracks in the general prohibition on interstate banking. However, on closer examination, there are many other equally important though less visible examples. Edge Act Corporations have become increasingly important in providing full banking services for international trade. Large banks have made loans on an interstate basis for many years through calling officers, and more recently through loan production offices. Interstate deposit gathering through brokers is becoming a widespread practice. Following the passage of the Bank Holding Company Act Amendments of 1970, which made it clear that there are no geographic limits on subsidiaries of bank holding companies, there was a dramatic increase in the operation of bank owned mortgage companies and commercial and personal finance companies on an interstate basis.

Savings and loan associations operate under considerably more liberal rules regarding branching than do banks. There are no statutory restrictions on interstate branching of federal savings and loans. In practice, interstate branching of federal savings and loans is prohibited by a regulation of the Federal Home Loan Bank Board, which is currently being reconsidered. Also, as previously noted, the significant financial problems encountered by thrift institutions in recent years have prompted the Federal Home Loan Bank Board to permit several interstate acquisitions of S&Ls by other thrift institutions. In conjunction with the expanded powers granted by the Garn-St Germain Act, which permit S&Ls to make commercial and agricultural loans, consumer loans, to own and lease tangible personal property, and to take commercial demand deposits in connection with commercial loans, S&Ls can offer essentially all the services of banks but are subject to fewer geographic limitations.

In addition, non-banks now offer many bank services without any geographic restrictions. The most obvious examples are the cash management type accounts offered by an increasing number of financial institutions. These accounts combine a savings vehicle such as a money market fund; investment vehicles such as stocks, bonds, mutual funds, unit investment trusts, and other financial instruments; transactions vehicles such as checks and credit cards; and credit vehicles such as overdraft protection and margin loans. The other bank-like activities of other financial institutions not defined as banks have been discussed at length earlier in this testimony. Suffice it to say that these firms are not subject to geographic limitations on where they conduct their business, enabling them to directly tap lucrative markets that most banks can enter only indirectly and on the limited scale outlined above.

In response to market pressures, several states have recently liberalized intrastate bank branching rules. Moreover, several states have chosen to exercise their authority under the Douglas Amendment to the Bank Holding Company Act to allow out-of-state bank holding companies to acquire an in-state bank. Some states allow out-of-state bank holding companies to acquire a state bank if the acquiring bank's state offers reciprocity. Some states permit out-of-state bank holding companies to operate limited bank service subsidiaries. Alaska is the first state to permit out of state bank holding companies virtually unlimited entry for full service activities. In the most recent example, a very rapid change in law was made in the state of Washington to allow an out-of-state acquisition of a large troubled bank.

ECONOMIC POLICY

Before concluding, I would like to comment briefly on economic policy. The opinions expressed here are based on careful consideration of the issues by our Economic Advisory Committee, a group of senior level economists at major banking institutions across the country, and are shared by a very large number of bankers. A copy of the Committee's statement of the Federal budget is attached to this statement as Appendix H.

A stable financial system can only be achieved if the overall economy is strong and healthy. Thus, any discussion of the conditions necessary for the stability of our financial system is incomplete without a discussion of governmental economic policy including both monetary and fiscal policies.

Turning first to fiscal policy, we are particularly concerned that the large deficits forecast for fiscal years 1985 and beyond will result in real interest rates being higher than they would have been at lower levels of deficits. These high deficits and increased real interest rates will have adverse effects on the economy. To reduce these budget deficits and decrease their adverse effects, reductions in Federal government expenditures must be achieved. All sectors of expenditures should be candidates for reduction. Since defense and direct benefit payments for individuals were predicted to total 71 percent of government expenditures in fiscal year 1984, these areas must be examined closely.

We are skeptical of the benefits of advocating tax increases. Tax increases may have a negative impact on the long run health of the economy, and experience with past tax increases indicates that, after their effects are considered along with other budget decisions that accompany their enactments, deficits are rarely decreased.

Failure to significantly reduce the size of the Federal deficit means that monetary policy will carry the entire burden of preventing a renewed burst of inflation. This pressure on monetary policy comes at a time when interpretation of the monetary aggregates is complicated by the continued development of new financial instruments. Regulatory restrictions such as rate ceilings and the imposition of sterile reserve requirements on deposit instruments have created incentives to develop new finacial instruments that are close substitutes for deposit instruments, but are not subject to the restrictions. We believe that the elimination of all regulatory constraints that make deposit instruments less attractive than non-deposit instruments will facilitate the design and implementation of an effective monetary policy.

We oppose legislative proposals that would reduce the independence of the Federal Reserve System. While a continuing dialogue between Congress and the Federal Reserve is a constructive element in the design of monetary policy, we believe that the long range goal of a stable price level can best be achieved when decisions on the implementation of monetary policy are made by the Federal Reserve. The Federal Reserve must continue to have the degree of independence necessary to make operating decisions unfettered by short-term political considerations.

The financial health and stability of other nations in the world has an important effect on the financial health and stability of the U.S. The unexpected and prolonged recession from which the world economy is only now emerging has tested the strength of the world financial system, and has brought some debtor countries perilously close to the brink of default. During periods of economic stress, the International Monetary Fund plays a key role in preserving the health and stability of the world financial system. For example, only the International Monetary Fund has the authority to impose adjustments on debtor countries designed to restore their financial health. However, these restrictions can be imposed only when the International Monetary Fund has funds to lend. We urge the Congress to quickly pass the proposed increase in the IMF quota without imposing restrictions on international lending which would limit the efficiency and flexibility of our international financial system.

CONCLUSION

The U.S. financial system is at an important crossroads. We must decide whether we will proceed on our journey down the road to deregulation begun with the passage the Depository Institutions Deregulation and Monetary Control Act of 1980 and continued with the passage of the Garn-St Germain Depository Institution Act last year. Continuation down this road requires the regulatory changes described above, the most urgent being to allow commercial banks and other financial institutions to provide a broader range of products and services. We believe such a course is necessary to allow the evolution of a continually more efficient financial system which provides greater convenience to users of financial products and services at lower cost. The alternatives are to stop the deregulation process or to impose even more stringent regulations on banks and their competitors. We believe that this course will lead to a less efficient financial system in the long run. Moreover, we are not sure such a course is even feasible given the direction of developments in the marketplace over recent years.

APPENDIX A

ASSESSMENT OF BUSINESS EXPANSION OPPORTUNITIES FOR BANKING

by

Arthur Young & Company

Project Summary

FOREWORD

In recent years non-bank institutions have come to offer an ever increasing number of services that are similar to the services offered by commercial banks. This trend has generated increased discussion of the appropriateness of the boundaries that have separated commercial banking and other activities. In many cases these boundaries limit bank provision of non-banking services more effectively than they limit other institutions from offering banking services. There is a growing awareness that such limitations could make it increasingly difficult for commercial banks to effectively compete against other types of financial institutions. Such a result would be unfortunate not only for commercial banks, but for millions of their customers as well.

Our Association's Government Relations Council, Economic Advisory Committee, and Ad Hoc Committee on Thrift Institution Restructuring have considered many of these issues over the past few years. As a result of their deliberations the ABA decided to undertake a study of the potential for profitable expansion of bank services. The study focused on those service areas where law and regulation clearly limited the ability of banking organizations to operate or about which there was some dispute concerning banking's legal status at the time the study was initiated. It should be noted that the legal or regulatory status of some of the services studied has changed since the study was begun.

In order to accomplish the goals of the study, a detailed outline of research needs was drafted by the ABA's Economic and Policy Research staff with the assistance of several banker committees. The outline was put into the form of a request for proposals that was sent to seventeen major consulting firms. A special oversight committee was formed with representatives from the Association's Economic Advisory Committee, Community Banking Leaders Council, and Corporate Planning Division. This group read proposals and heard presentations from several of the consulting firms that responded to the request for proposals. They selected Arthur Young and Company to do the project. The committee carefully reviewed the research at all stages and believes the study team did a thoroughly professional job. Although we do not necessarily agree, either individually or as a group, with all of the conclusions reached by the consultants, we feel the methodology and conclusions embodied in the study are well-founded and worthy of the thoughtful consideration of all forward thinking commercial bankers.

Members of the oversight committee are:

Representing Economic Advisory Committee

Stanley R. Reber, Chairman
Senior Vice President
Texas American Bancshares, Inc.
Fort Worth, Texas

Robert E. Knight
President
Alliance National Bank
Alliance, Nebraska

Thomas D. Thomson
Senior Vice President and Chief Economist
Crocker National Bank
San Francisco, California

Representing Community Banking Leaders Council

James H. Oliver
Chairman
Commerical National Bank and Trust Co.
Grand Island, Nebraska

John B. Hamby Jr.
President
Glastonbury Bank and Trust Co.
Glastonbury, Connecticut

Lyle McKinley
President
Citizens National Bank
Cheboygan, Michigan

Representing Corporate Planning

David E. Gile
Senior Vice President
Marine Midland Bank
New York, New York

Stuart C. MacIntire
Senior Vice President
First Bank System, Inc.
Minneapolis, Minnesota

Harry J. Weitzel, Jr.
Senior Vice President
Maryland National Bank
Baltimore, Maryland

Staff assistance was provided by P. Michael Laub, Director of Economic and Policy Research at the ABA, Charles Hoffman, Economist, of his staff, Sean Kennedy, Associate Director, Community Banking Leaders Council, Dorie Leeper, Assistant Director, Corporate Planning Division, and Roger Hawkins, Director of Management and Professional Education/Research, Banking Professions Group. Additional assistance was provided by two independent consultants who were not directly involved in the research, Charles F. Haywood, Professor of Finance, University of Kentucky, and Sam Chase of Samuel Chase and Company. The Project Director for the Arthur Young team was Anat Yalif, Director of the Strategic Planning Practice for Arthur Young and Company. The Partner in Charge was David Reynolds. The third member of the team was Alfred Brothers, Senior Consultant at Arthur Young and Company.

This study must be viewed as but an initial step in an ongoing process culminating in what we hope will be a banking consensus on the legislative and regulatory changes that are needed to allow profitable expansion of the services offered by commercial banks. This consensus can only be attained if a large number of banks evaluate their own market opportunities and compare their conclusions with those described in the following pages.

As deregulation of the banking industry proceeds, each banking institution will be faced with the need for a strategic plan that identifies the services it should provide to its customers. I believe a close reading of the following study can play an important role in nurturing that planning process.

Sincerely,

Stanley R. Reber

EXECUTIVE SUMMARY

I. PURPOSE

Recognizing the changing structure of the financial services industry, the American Bankers Association has commissioned a study to assist it in advising its membership on deregulation policy. The purpose of the study is not to predict the future of the banking industry. Rather, the objective is to assess the feasibility and profitability of bank entry into selected service markets from which they were formerly or are currently prohibited or partially prohibited by regulatory constraints. However, since the banking industry is not homogeneous, feasibility, profitability, and ease of entry were assessed separately for three size groupings of banks and three assumed state regulatory environments. Study results apply for general banking industry segments. However, many banks will have unique circumstances that will constitute exceptions to these generalized conclusions. Thus study results may not be applicable to a specific bank's situation.

Thirteen service markets[1] selected by ABA were reviewed to assess the potential opportunities for bank entry within the next decade. These included:

- Securities underwriting
- Securities brokerage
- Mutual funds
- Commodities and futures brokerage

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[1] The legislative status of many of these service markets has changed since the study's inception.

- Insurance underwriting
- Insurance brokerage
- Travel agency
- Telecommunications
- Data processing
- Real estate brokerage
- Real estate equity
- Non-full payout leasing
- Management consulting (including tax advisory services)

Other potential activities could have been included. A number of questions were addressed by the study for each service market:

1. Is the line of business a good one to be in?
    - Has the business been profitable in terms of return on assets, return on equity, or sales margin?
    - Has the market grown rapidly? (Presumably faster growing markets would be easier to enter.)
    - Will profitability or growth change in the years ahead in response to technological, demographic or other changes?
    - Are customer relationships generally stable within the market?

2. Do banks[2] have any resources or unique characteristics or capabilities that increase the likelihood of successful entry into the market in question?

   - Does the product or service involve the same customer base?

   - Does it involve similar skills or expertise?

   - Is it closely related to transactions or other services offered by banks?

   - Do other types of financial or non-financial institutions have similar advantages? If so, do they seem poised to enter the market?

   - Does the image of banking provide any advantage in offering the product or service? Does offering the product or service affect the bank's image?

   - Can the product or service be offered through the bank's existing locations?

   - Do banks have any locational advantages in the market?

   - Can customer contacts (personal, telephone, mail) be piggybacked on existing contacts made by the bank?

   - Is the market subject to strong seasonal or cyclical influence? If so, how do these fit into the bank's seasonal or cyclical resource needs?

[2] The term "bank" refers to all types of banking organizations, including bank holding companies.

- Can the service best be offered through the bank or through the holding company?

3. Are there entry barriers other than the legal prohibition against banks offering the service?

    - How much capital is required for entry?

    - Are there dominant firms within the industry?

    - Is a large volume required to provide the product or service efficiently?

4. Are there any characteristics of the line of business that would seem to prohibit bank entry into it for public policy reasons?

    - Does entry into the market adversely affect the safety and soundness of the bank? If so, can this be offset by segregating the activity in a separate holding company subsidiary?

    - Does entry into the market create any conflict of interest for the bank? Would it help or hurt the bank's ability to offer existing services?

5. What would be the effect of allowing banks to enter the line of business?

    - How fast would they enter the business?

    - What level of resources will they put into it?

    - How would entry affect prices within the market?

    - What will be the effect on bank profitability?

- How will the answers to these questions vary with different scenarios for prospective economic conditions?

6. How will the answers to these questions vary for different types of banks?

   - Money center bank (assets greater than $20 billion)

   - Regional bank ($1 to $20 billion in assets)

   - Medium size bank ($250 million to $1 billion in assets)

   - Community bank (less than $250 million in assets)

   - Unit banking state

   - Limited branching state

   - State without branching restrictions

II. METHODOLOGY

The overall study question - what are those service markets which would provide attractive opportunities for commercial bank entry in the next decade - is comprised of two key components:

- Assessment of market attractiveness. How attractive are the service markets for any potential entrants?

- Assessment of bank positioning. How well are banks positioned to enter these service markets? In other words, an attractive market, by itself, is not sufficient to justify entry. Banks may be ill suited to enter an otherwise attractive market, thus rendering it unattractive to the banking industry, while potentially attractive for others. For example, computer manufacturing may be an attractive market. However, banks are not well-positioned for entry. Conversely, securities brokerage is an attractive market for which banks may be particularly well-positioned.

The market attractiveness/business strength approach underlies the conceptual framework for this study. This approach combines analysis of the attractiveness of each service market, as defined by a specific list of factors, with the analysis of the positioning, competitive edge and potential strengths of commercial banks in entering the service market. The consolidated analysis of bank positioning in the service market yields an estimate of service profitability and identifies those service markets which present significant potential for bank entry.

The study was conducted in three phases. Phase I assessed the market attractiveness of the service markets. Examples of criteria used in the assessment include:

o	Profitability	-ROA and ROE, current and trend -revenue, current and trend -revenue growth
o	Market structure	-number of firms -market concentration -extent of market dominance -market growth -customer profile -customer sensitivity factors -customer vendor selection criteria
o	Risk analysis	-bankruptcy rate -business risk -capital risk -obsolescence risk -vulnerability to change (regulation, technology, etc.)
o	Entry barriers	-capital intensity -human capital requirements -market dominance -competitive profile

At the conclusion of Phase I, each service area was profiled and its attractiveness assessed. Exhibits II and III, presented in the next section, summarize the findings of Phase I.

Phase II focused on commercial banks' ability to profitably enter the service markets. In that context, the study recognized the heterogeneity of the banking industry and variation in bank positioning by industry segment. Therefore, feasibility and ease of entry were assessed separately for four size groupings: community banks, medium-sized banks, regional banks, and money center banks, as well as three different state regulatory environments: unit, limited branching, or state-wide branching. Regulatory environment had little impact on bank positioning except as it related to distribution networks. Thus, regulatory impact on positioning is discussed in each separate industry analysis. Similarly, few material differences were found between medium size and regional banks. Consequently, the two groups were combined for analysis purposes.

Phase II concentrated on the advantages and disadvantages that banks currently possess in considering entry into each of the service markets. Criteria to assess bank positioning included:

- Transferability of customer base
- Relevance of existing distribution systems
- Importance of existing customer relationships
- Availability of skills
- Impact of bank image
- Applicability of bank personnel policies
- Capital availability.

Input into the assessment included interviews with 32 banks of different sizes and discussions with Arthur Young banking specialists and other industry experts. Exhibit I presents the geographic and size distribution of the banks interviewed.

At the conclusion of Phase II, bank positioning with respect to each service market was assessed. Exhibit IV, presented in the Findings section, summarizes the findings of Phase II.

Phase III combined the results of the first two phases to yield the final conclusions of the study, identifying those services which offer significant opportunities for the banking industry. Exhibits V, VI and VII summarize these conclusions.

EXHIBIT I

BANK DISTRIBUTION BY SIZE AND GEOGRAPHIC LOCATION

	North East	South East	Mid West	North Central	West
Money Center	3	0	1	0	2
Regional	2	2	2	1	1
Medium Size	1	2	2	0	1
Community	2	2	4	3	1
Total:	8	6	9	4	5

III. FINDINGS

1. Market Attractiveness

Exhibits II and III, presented in this section, outline the findings of Phase I. Exhibit II presents profitability by service market. Pre-tax ROE, ROA and profit margins are displayed. Exhibit III presents other variables which were considered in service market attractiveness assessment. These include growth, cyclical nature, market concentration, capital requirements, human capital requirements, and critical mass needed. These variables, in conjunction with profitability, were evaluated to assess the attractiveness of each service market. A synopsis of the findings is presented below:

Non-Full Payout Leasing

This segment of the leasing industry typically involves short-term operating type leases with the lessor assuming risk associated with ownership of used equipment. Leasing revenues have declined with the current recession reflecting decreased demand for capital equipment. This service market is capital intensive; in addition, it requires staff with the capability to appraise and sell used equipment.

Commodity and Financial Futures Brokerage

Service market growth in this area is attributed to increasing use of financial futures by hedgers and speculators. In 1981, 100 million futures contracts were traded, double 1978 volume. The industry is highly concentrated: the top ten brokerage firms account for 95% of industry revenues. These firms' dominance is reinforced by requirements for personnel with highly specialized investment skills.

Data Processing

This service market consists of four segments; processing services, software products, professional services and turnkey systems. Recent revenue growth and profitability are expected to continue into the future as new data processing applications are developed. This growth, especially in the software and turnkey systems segments, promotes market attractiveness. Capital requirements for entry are relatively high for the processing services segment and significantly lower for the professional services segment. Qualified personnel represent a critical factor determining success in this market.

Insurance Agency/Brokerage

Profitability, as measured by return on equity (ROE), for the insurance agency/brokerage service market has declined in recent years. This market is characterized by few entry barriers, low industry concentration, and low capital requirements. As insurance underwriters continue to reduce premiums and new distribution channels are developed, service market profitability growth may be inhibited.

Insurance Underwriting

Investment income is becoming increasingly important to this service market. Net property/casualty premiums grew 3.6% from 1980 to 1981, while life/health premiums increased 11.2%. Despite moderate capital entry requirements, industry concentration and competition from the financial services industry have resulted in lower premiums and may contribute to reduced growth and profitability.

Management Consulting/Tax Advisory Services

These service markets are characterized by low entry capital requirements, low critical mass and high personnel skill requirements. The management consulting service market has contracted in recent years while maintaining above average return on equity. Profitablity appears to be inversely related to firm size, with smaller firms having superior pre-tax earnings yet similar liquidity to large firms.

Mutual Funds

The performance of investment advisory firms, the managers of mutual funds, is related to the size of fund assets. Low capital requirements combined with increasing demand for high yielding money market mutual funds have contributed to dramatic growth and profitability. As the market for mutual funds matures, investment expertise provided by highly skilled investment managers will be a prime determinant of an investment advisory firm's success.

Real Estate Brokerage

The recent decline in the demand for housing has contributed to limited growth and reduced profitability of this service market which moves with overall economic conditions. Low capital requirements, low critical mass and relatively high profit margins may make this service market increasingly attractive when the demand for housing resumes. National brokerage firms have obtained a large share of the national market but have been less successful in penetrating smaller real estate markets.

Real Estate Equity

The cyclical market for real estate ownership and development, property management and other real estate activities has declined in recent years. However, real estate investment can provide attractive returns during inflationary periods. Equity investment in real estate is capital intensive and can require substantial expertise or experience in real estate markets.

Securities Brokerage and Underwriting

The securities brokerage market is highly profitable, concentrated among a relatively small number of large firms, and requires skilled investment advisory and sales personnel. Capital requirements are generally low for introducing firms and somewhat higher for those firms carrying margin accounts. Discount brokerage is somewhat less profitable, less concentrated and significantly less skill intensive than full service brokerage. Securities underwriting is also profitable, concentrated among a small number of firms and requires significant amounts of capital and specialized personnel expertise.

Telecommunications

This service market, narrowed in scope to focus on videotex and electronic mail, is in an early stage of development. A number of firms are testing systems of various types and introducing new products. Videotex and electronic mail systems in current use require significant capital outlays and the participation of skilled technicians and engineers. As a result, a system must reach a critical mass to become viable.

Travel Agency

This service market is characterized by significant growth in number of firms and revenues but has displayed relatively low profit margins. Low capital requirements and less specialized personnel facilitate ease of entry and contribute to relatively high pre-tax ROE and ROA. Despite market positioning by financial services firms such as American Express, no particular firm or group of firms has achieved market dominance.

2. Comparative Analysis

The following exhibits summarize service market assessment and facilitate comparisons across service markets studied.

Exhibit II presents profitability by service market and service market segment. Pre-tax return on equity (ROE), return on assets (ROA), and profit margin for 1980 are displayed. Where available, five year financial information was used. In all cases, industry profitability should be considered in conjunction with industry economic cycles and other factors to assess profitability potential. Accompanying explanatory notes and documentation constitute an integral part of this exhibit.

Service market return on equity ranged from 64% for the securities market (introducing firms) to 17.2% for the property/casualty insurance underwriting service market. Above average return on equity is also reported for securities underwriting, securities brokerage (carrying firms), the software segment of data processing, and management consulting.

Return on assets (ROA) figures were not as widely available. Observed differences in ROA are attributable to service market profitability and capital intensity. Relatively capital intensive but less profitable industries such as insurance underwriting indicated low ROA and more profitable industries such as the software segment of the data processing service market display the highest ROA.

Profit margins range from a high of 15.7% for the securities brokerage service market (carrying firms) to a low of 4.7% for the travel agency service market. Profit margins tend to follow capital intensity, those areas with greater capital intensity displaying higher pre-tax profit margins.

PROFITABILITY

EXHIBIT II

	1980 RETURN ON EQUITY	1980 RETURN ON ASSETS	1980 PROFIT MARGIN
EQUIPMENT LEASING[1/]	12.5%[9/]	1.6%	NA
INSURANCE AGENCY/BROKERAGE	29%	5.9%	9.7%
INSURANCE UNDERWRITING			
PROPERTY/CASUALTY	17.2%[10/]	NA	NA
HEALTH/LIFE	10-17%[11/]	NA	NA
COMMODITY AND FINANCIAL FUTURES BROKERAGE[2/]	NA	NA	NA
DATA PROCESSING[3/]			
PROCESSING SERVICES	18.1%	10.9%	13%
SOFTWARE	53%	20.4%	12%
TURNKEY SYSTEMS	15.7-32%	6.6-15.5%	14%
PROFESSIONAL SERVICES	27.3%	8.8%	7%
MANAGEMENT CONSULTING	36.8%	12.8%	7.8%
TAX ADVISORY SERVICES[4/]	42.1%	29.6%	14.0%
TRAVEL AGENCY	28.9%	7.8%	4.7%
REAL ESTATE EQUITY[5/]	NA	NA	NA
REAL ESTATE BROKERAGE	21.1%	5.2%	14.0%
MUTUTAL FUNDS[6/] (INVESTMENT ADVISORY SERVICES)	NA	NA	NA
SECURITIES BROKERAGE[7/]			
CARRYING FIRMS	39%	31%	15.7%
INTRODUCING FIRMS	64%	57%	10.2%
SECURITIES UNDERWRITING[8/]	49%	NA	NA
TELECOMMUNICATIONS	NA	NA	NA

NA: NOT AVAILABLE

THE ACCOMPANYING NOTES ARE AN INTEGRAL PART OF THIS EXHIBIT.

NOTES - Exhibit II

1: Equipment leasing includes full payout and non-full payout leasing.

2: ROE, ROA, and profit margins for commodities and financial futures brokerage were not available. The service area assessment presents ranges of brokerage commissions. Actual commissions, ROE, ROA, and profit margins may be similar to those of securities brokerage firms.

3: ROE, ROA, and profit margins and 1980 averages reported by service market segment. Figures were reported in the 1980 Input-ADAPSO study of the data processing industry.

4: 1981 figures are reported for one firm only, H&R Block, Inc. As such, they may not be representative of this industry nor valid for inter-service area comparisons.

5: ROE, ROA, and profit margins were not available for this industry. Service market performance is suggested as a percent of cash flow, real estate assets and dividends to real estate investors.

6: ROE, ROA, and profit margins were not available for this industry. Service market assessment indicates that profitability is directly related to fund asset size.

7: Service market ROE is calculated as a single ratio. ROE equals total service market pre-tax earnings as a percent of total service market equity. ROA and profit margins were not available.

8: Securities underwriting ROE is calculated as a single industry ratio, as in the case of securities brokerage (note 7).

9: ROE and ROA are calculated as net income before taxes as a percent of net worth or assets for 1981.

10: ROE for the property/casualty segment of the insurance underwriting service market is calculated as net income after taxes as a percent of net worth for 1979. ROA and profit margins were not available.

11: ROE for the health/life segment of the insurance underwriting service market is calculated as net income after taxes as a percent of net worth for 1980.

Exhibit III presents service market characteristics such as size (number of firms), recent revenue growth and growth potential, cyclical nature (sensitivity to economic cycles), industry concentration, human capital requirements and critical mass. The exhibit summarizes data from a variety of sources. These data are also presented separately in each service market assessment.

The service markets with the largest numbers of firms were real estate brokerage, tax advisory services and travel agency. Without definitive information, the insurance agency service market is composed of a large number of relatively small firms. Securities underwriting, investment advisory firms, and the commodity and financial futures brokerage areas are composed of a relatively small number of firms.

The data processing, telecommunications, and mutual fund service markets have demonstrated relatively strong revenue growth compared to slower growth areas such as insurance underwriting. Growth prospects are expected for several of the service markets analyzed including: commodity and financial future brokerage, certain data processing industry segments and telecommunications. Service markets with lower growth prospects include insurance underwriting and brokerage, securities underwriting and brokerage, management consulting and real estate brokerage and equity.

Potential growth for certain industries tends to be closely tied to general economic growth. Growth in the areas of insurance brokerage and underwriting, management consulting and tax advisory services, travel agency and real estate brokerage and equity is likely to be particularly dependent on renewed economic growth. Other service areas such as data processing, telecommunications, securities brokerage, investment advisory services (mutual funds) and commodities and financial futures brokerage appear to be less dependent on general economic trends for continued growth.

EXHIBIT III

	NUMBER OF FIRMS	RECENT OR PROSPECTIVE GROWTH			ENTRY BARRIERS/EASE OF ENTRY				
		1980-81 REVENUES	GROWTH POTENTIAL	CYCLICAL	INDUSTRY CONCENTRATION TOP 10	INDUSTRY CONCENTRATION TOP 25	CAPITAL REQUIREMENTS	HUMAN CAPITAL REQUIREMENTS	CRITICAL MASS
EQUIPMENT LEASING	1/NA	NA	MEDIUM	YES	13/NA	NA	HIGH	HIGH	MEDIUM
INSURANCE AGENCY/BROKERAGE	2/ NA	6/14%	LOW	YES	NA	NA	LOW	LOW/ MEDIUM	LOW
INSURANCE UNDERWRITING									
PROPERTY/CASUALTY	900	7/4%	LOW	YES	NA	NA	MEDIUM	HIGH	HIGH
LIFE/HEALTH	1,948	11%	LOW	YES	NA	NA	MEDIUM	HIGH	HIGH
COMMODITY AND FIN FUTURES	400	8/ 25%	HIGH	NO	95	NA	LOW	HIGH	LOW
DATA PROCESSING									
PROCESSING SERVICES	2,150	9/ 14%	MEDIUM	NO	33%	49.5%	HIGH	HIGH	MEDIUM
SOFTWARE	1,000-2,000	34%	HIGH	NO	44%	62%	MEDIUM	HIGH	LOW
TURNKEY SYSTEMS	1,500	30%	HIGH	NO	NA	NA	MEDIUM	HIGH	MEDIUM
PROFESSIONAL SERVICES	1,000	25%	HIGH	NO	(13) 42%		LOW	HIGH	LOW
MANAGEMENT CONSULTING	2,500	NA	LOW	YES	(15) 51%	NA	LOW	HIGH	LOW
TAX ADVISORY SERVICES	3/ 200,000-300,000	NA	LOW	NO	(1) 10%	NA	LOW	MEDIUM	LOW
TRAVEL AGENCY	20,000	10/ 18%	MEDIUM	YES	NA	NA	LOW	LOW	LOW
REAL ESTATE EQUITY	120	NA	LOW	YES	NA	NA	LOW	HIGH	LOW
REAL ESTATE BROKERAGE	4/ 650	11/ NA	LOW	YES	(11) 20-39%	NA	LOW	LOW	LOW
TELECOMMUNICATIONS	500-1,000	16%-30%	HIGH	NO	NA	NA	HIGH	HIGH	HIGH
MUTUAL FUNDS	5/250/750	12/34%	MEDIUM	NO	45.8%	(20) 64%	LOW	HIGH	HIGH
SECURITIES BROKERAGE	5,000	NA	·		(8) 39%	61			
CARRYING FIRMS	·	NA	LOW	NO	NA	NA	HIGH	HIGH	MEDIUM
INTRODUCING FIRMS	·	NA	LOW	NO	NA	NA	LOW	HIGH	LOW
SECURITIES UNDERWRITING	20	NA	LOW	YES	(8) 41%	68%	HIGH	HIGH	HIGH

NA NOT AVAILABLE

THE ACCOMPANYING NOTES ARE AN INTEGRAL PART OF THIS EXHIBIT

NOTES - Exhibit III

1: Equipment leasing includes full payout and non-full payout leasing.

2: A precise estimate of the number of insurance agencies/brokerage firms was not available.

3: Number of income tax preparers.

4: Control Data information service estimate of the number of real estate agent and management companies. This figure includes companies which may not be real estate brokerages and may not include all small real estate brokerage firms.

5: In 1982, 250 investment advisory firms provided services to approximately 750 mutual funds.

6: Revenue growth for insurance brokers.

7: Growth in premium income.

8: Cumulative annual growth rate in total contracts traded from 1977 to 1981 was 25%.

9: The figures presented for the data processing service segments represent average annual revenue growth between 1976 and 1981.

10: The figure presented represents average annual revenue growth between 1970 and 1981.

11: Estimated annual revenue growth for the telecommunications service sector.

12: Growth in fund asset size.

13: The figure in parentheses represents the number of firms with the market share indicated.

Entry potential and attractiveness is influenced by industry concentration. The presence of dominant firms was particularly apparent in the real estate equity area, securities brokerage and underwriting, management consulting, and commodity and financial futures brokerage. Less concentrated market areas were typically characterized by large numbers of firms and included telecommunications, real estate brokerage, travel agency services, and insurance agency and brokerage.

Capital requirements for entry differ across the service areas studied. The data processing services segment, telecommunications, securities carrying firms and the securities underwriting areas have relatively high capital entry requirements. Professional services and brokerage areas have substantially lower capital entry requirements. In such cases, working capital is often sufficient for entry and operation. Non-capital intensive areas include management consulting, insurance agency/brokerage, commodity and financial futures brokerage, tax advisory services, real estate brokerage, investment advisory services (mutual funds), and securities brokerage (introducing firms).

Highly skilled professionals represent a critical success factor for a number of the service markets studied. Securities brokerage and underwriting, investment advisory services (mutual funds), telecommunications, data processing, management consulting and insurance underwriting require staff with specialized skills. Skilled professionals in these areas are sought after and as a result may command relatively high salaries.

Management and personnel skills are also critical to the success of firms in the other service areas studied. However, technical and professional skills required for these service areas may be more accessible or may be more easily acquired through re-training.

Service areas with greater critical mass frequently involve greater capital investments. Telecommunications, securities underwriting, and insurance underwriting all have a certain critical mass, that is, a level of revenues required to provide sufficient return on investment. Mutual funds operated by investment advisory services also require a critical mass in fund assets because the fixed cost portion of fund management costs are signficant, and the fixed costs of fund operation are not strongly related to fund size. Thus, smaller funds may not generate sufficient income to be profitable.

In summary, the following service market attractiveness ranking emerged:

SERVICE MARKET ATTRACTIVENESS

HIGH	MEDIUM	LOW
Securities Brokerage Discount Brokerage Securities Underwriting Real Estate Equity Insurance Brokerage Data Processing Futures Brokerage	Real Estate Brokerage Management Consulting Mutual Funds Telecommunications	Travel Agency Non-Full Payout Leasing Insurance Underwriting

Market attractiveness was determined independently of the potential entrant. In assessing each service market's attractiveness, a composite of the market attractiveness variables considered determined its ranking. For example, securities brokerage was found to be highly attractive due to high profitability, low critical mass and low to medium capital requirements. Discount brokerage was also found to be highly attractive despite somewhat lower profitability since its skill intensity and concentration were lower than securities brokerage, and other characteristics were similarly attractive. Conversely, travel agency represented a less profitable market which is highly susceptible to adverse regulatory changes, thus rendering it unattractive. In other words, assessment of market attractiveness considered the combination of all variables studied, rather than each variable separately.

Profitability was an important attractiveness variable. Three measures of profitability were examined. The relative importance of each varies by the service market assessed. Thus, using one profitability measure across businesses may be misleading. In many cases, ROE was the most appropriate measure used.

3. Bank Positioning

Exhibit IV presents Phase II findings which assessed bank positioning toward entry into each of the service markets studied. Critical variables in assessing bank positioning include:

- Customer base transferability - can the new service be sold to current bank customers, either retail, commercial or both?
- Distribution system leverage - does the branch network or correspondent network constitute an advantage? Can it be used to distribute the service?
- Image - is bank image an advantage in positioning to provide the service? Would bank image be negatively impacted by entry?
- Product/service fit - does the product fit well into the existing bank product portfolio? Is the new product synergistic with current bank products?
- Skill fit - can existing bank skills be used or expanded to offer the new service?
- Personnel policies fit - are existing bank personnel practices similar to personnel policies usually associated with the new service?
- Defensive motivation - is it important to offer the service to retain customer relationships? Are newcomers into the financial services industry or bank competitors using the service to create a competitive edge over banks?

EXHIBIT IV
COMMERCIAL BANK POSITIONING FOR SERVICE MARKET ENTRY

	Customer Base Transferability	Distrtribution System Leverage	Bank Image	Product Synergism	Skill Similarity	Personnel Policy Similarity	Risk to a Bank	Defensive Motivation for Entry
REAL ESTATE BROKERAGE	HIGH	HIGH	HIGH	HIGH	LOW	LOW	LOW	HIGH
REAL ESTATE EQUITY	HIGH	NS	MEDIUM	HIGH	MEDIUM	HIGH	MEDIUM	HIGH
TRAVEL AGENCY	HIGH	HIGH	MEDIUM	LOW	LOW	HIGH	LOW	LOW
DATA PROCESSING	MEDIUM	NS	MEDIUM-LOW	MEDIUM	MEDIUM-HIGH	HIGH	MEDIUM	LOW
TELECOMMUNICATIONS	HIGH	NS	LOW	MEDIUM	LOW	MEDIUM	MEDIUM	HIGH
MANAGEMENT CONSULTING	MEDIUM	NS	LOW	MEDIUM	MEDIUM	MEDIUM	LOW	LOW
NON-FULL PAYOUT LEASING	HIGH	NS	HIGH	HIGH	MEDIUM	HIGH	HIGH	LOW
INSURANCE BROKERAGE	HIGH	HIGH	HIGH	HIGH	LOW	LOW	LOW	HIGH
INSURANCE UNDERWRITING	LOW	NS	LOW	LOW	LOW	MEDIUM	HIGH	LOW
SECURITIES BROKERAGE	HIGH	HIGH	MEDIUM	HIGH	LOW	LOW	LOW	HIGH
SECURITIES UNDERWRITING	MEDIUM	HIGH	LOW	HIGH	LOW	LOW	MEDIUM	HIGH
MUTUAL FUND MANAGEMENT	HIGH	HIGH	HIGH	HIGH	MEDIUM	MEDIUM	LOW	MEDIUM
FUTURES BROKERAGE	HIGH	NS	LOW	HIGH	LOW	LOW	LOW	MEDIUM

NS : Not Significant

- Risk - is there significant risk associated with bank entry into the service market. Many factors contributing to risk were considered, including customer loss, relative capital intensity, technological obsolescence and others.

A synopsis of the findings is presented below:

- Securities Brokerage - Bank customers provide a natural market for both discount and full service brokerage. The branch network can be used effectively for distribution purposes. Banking's image as trustworthy, credible institutions provides a competitive advantage. Securities brokerage to both commercial and retail customers fits well into the existing bank service mix as a fund placement tool for customers - an integral part of a full financial services package. Banks typically do not have existing skills to offer full service brokerage (although many can offer discount brokerage with existing personnel). Further, bank personnel policies are significantly different from the incentive compensation system used by full service brokers. Therefore, modification is necessary for an effective, full service brokerage operation. Discount brokerage, transaction execution only, is compatible with existing personnel policies. The service is not capital intensive and thus involves little risk. Business risks are limited to customer loss through bad advice. Securities brokerage firms are already moving into the banking business. Thus, banks may need to offer the service for defensive reasons.

- Securities Underwriting - Bank corporate and public sector customers use securities underwriting services. Banks with a strong commercial base are well positioned to offer such services to their customers as another way of financing longer term capital. Bank distribution networks - both customers and correspondents - are critical to successful distribution of new issues. Banks, however, presently lack the image, experience, expertise, and compensation structure required to compete successfully in the underwriting business. They also will be exposed to underwriting and distribution risks as well as potential conflicts including those addressed by the Glass-Steagall Act. However, banks need to defend their commercial relationships against new entrants, including brokerage firms and investment bankers, offering these services.

- Mutual Funds - Mutual funds are demanded by bank customers, as evidenced by the migration of deposits from banks to mutual funds. The need to offer similar yield and liquidity for defensive reasons produced the new money market account. The funds can be marketed via the branch network to offer customer convenience. Banks are not necessarily known as fund managers, except banks with strong trust departments. Such banks already possess some fund management skills which they will need to augment. As an investment vehicle, mutual funds fit well with existing bank products including trust, checking account and credit cards. Banks are in a position to package funds, securities brokerage and other financial services to achieve significant synergies. Bank personnel policies are not particularly well suited to motivate fund management and marketing. However, some banks with trust operations already employ appropriate compensation systems.

- Commodities and Futures Brokerage - A segment of bank customers will be interested in commodities and financial futures. Banks can add these products to their portfolio of investment vehicles to meet customer needs. Financial futures can be packaged with commercial lending. Banks typically do not possess the skills required to offer the service, the flexible personnel policies essential for motivation and retention of professionals, or the aggressive, innovative image typically associated with successful brokerage of these relatively new products. A branch system will not constitute a material advantage in offering the service, since its primary application is to wholesale, not retail, customers. The risk associated with the service is low, like other brokerage services, and centers around bad advice and transaction mismatches. Some competitors offer the service, thus warranting a defensive response.

Insurance Brokerage - Insurance is needed by most bank customer segments and fits well with present bank product lines. A branch system is highly relevant for distribution of retail insurance, and the banking industry's conservative, trust inspiring image is a competitive asset. Although banks lack the professional expertise, selling skills and incentive compensation systems necessary to provide insurance services, they may need to do so to compete against securities brokerages, insurance companies and other competitors which are entering the financial services industry. The risks associated with insurance brokerage are low.

Insurance Underwriting - The consumers of insurance underwriting are insurance brokers and agents, although some underwriters also broker insurance. In general, however, bank customer systems cannot be further leveraged. Bank image, lack of requisite skills, lack of product fit and heavy training needed for entry all contribute to relatively poor positioning. Lack of competitive advantages is accompanied by high underwriting risk and few competitive pressures motivating defensive strategy.

Travel Agency - Banks can sell travel services to both corporate and retail clients, and use branches as outlets. However, travel agency services are not highly synergistic with bank products and the skills required are different from existing bank skills. Bank image does not constitute an advantage in this service market. Travel agencies involve some risk from bad advice, and limited capital risks. Banks do not need to get into this business for defensive reasons.

- Telecommunications - Bank customers are a relevant market for telecommunications and information services. Banks do not enjoy other significant advantages: product synergism is limited; branch system is irrelevant; banks' conservative image is a handicap in this innovation-sensitive market; and bank skills cannot be leveraged, although they are already in the financial information business to some extent. Entry into telecommunications has defensive aspects, particularly in the protection of the payment mechanism and customer retention. It is, however, a risky market and vulnerable to technological obsolescence.

- Data Processing - Segments of bank corporate customers, particularly the middle market and small business, are potential customers of data processing services. Bank correspondent networks represent another potential market. Bank skills and experience can be leveraged if a bank has a data processing facility (only banks with such facilities or with service bureau relationships can offer the service). However, these skills may need strengthening. Product synergism is limited. Bank image provides little advantage and there is substantial risk in this obsolesence sensitive, often capital intensive service market.

- Real Estate Brokerage - Banks could offer the service to both retail and commercial customers. Their distribution network represents a significant advantage, as does their computerized information system (available at most banks). Real estate brokerage fits well with real estate financing, insurance and other financial services. Bank credibility and professional image provide another competitive edge. Bank skills and personnel policies cannot be readily applied to real estate brokerage but can be easily acquired. The service market offers little risk. Many non-bank competitors in the financial services industry offer real estate brokerage services and banks need to offer this service for defensive reasons.

- Real Estate Equity - Banks can utilize existing customers to facilitate entry into real estate equity markets. This activity fits with banks' existing portfolio of fund placement and investment services and utilizes some bank skills, especially where construction financing is done. Bank distribution networks and image provide limited advantages. Real estate equity involves market risk which could result in losses. Banks face competition in this area from thrifts and other institutions which can offer real estate equity services. Thus, defensive positioning is important.

- Non-Full Payout Leasing - Banks could offer some non-full payout leasing to targeted industry segments in their customer base. Bank positioning, particularly with respect to skill fit and customer base transferability, varies greatly among banks and depends upon bank credit concentration in capital intensive industries which are the prime customers of non-full payout leasing. Banks' image as a reliable financial institution is a competitive asset toward entry. The service complements other leasing products and financing mechanisms which banks already offer. Consequently, skills are partially transferable, yet must be augmented by leasing experts who are industry specialists and can manage the potentially large residual risk. This risk is combined with the credit risk and the capital risk. The defensive motivation for non-full payout leasing is limited..

- Management Consulting and Tax Advisory Services - Some bank commercial customers could be potential markets for management consulting services. Tax advice could be offered to both retail and wholesale customers, but is primarily a retail-oriented product. Banks typically do not have in-depth skills to offer consulting for fees in a defined market. They also lack the tax advisory skills. Bank image is not an asset in this service market. Some synergisms may result from consulting, and especially from tax advice such as IRAs, KEOGHs and other tax planning financial instruments. This service market involves little risk.

In summary, bank positioning in the service markets studied was grouped into three categories: high, medium and low positioning. Ranking varied by size of banks as shown in Exhibit IV-A.

Bank positioning rankings were developed through consideration of composite bank positioning across variables for each service market. For example, bank positioning to enter the real estate brokerage market was ranked "high" due to high product synergism, an existing customer base, distribution system, bank image and current bank products. Conversely, bank positioning to enter the insurance underwriting market was ranked "low" following low fit across these variables coupled with high bank entry risk.

Synergism with current bank products, as well as potential linkage with other new service markets, were of great importance in assessing bank positioning for entry into the service markets studied.

EXHIBIT IV A
BANK POSITIONING

BANK SIZE	HIGH	MEDIUM	LOW
LARGE	Securities Brokerage Discount Brokerage Real Estate Equity Insurance Brokerage Real Estate Brokerage Mutual Funds Non-Full Payout Leasing	Data Processing Securities Underwriting Futures Brokerage Management Consulting Travel Agency	Telecommunications Insurance Underwriting
REGIONAL & MEDIUM SIZE	Securities Brokerage Discount Brokerage Real Estate Equity Insurance Brokerage Real Estate Brokerage	Securities Underwriting Futures Brokerage Management Consulting Mutual Funds Travel Agency Non-Full Payout Leasing	Data Processing Telecommunications Insurance Underwriting
COMMUNITY	Discount Brokerage Real Estate Equity Insurance Brokerage Real Estate Brokerage	Securities Brokerage Securities Underwriting Travel Agency	Data Processing Futures Brokerage Telecommunications Management Consulting Mutual Funds Non-Full Payout Leasing Insurance Underwriting

IV. CONCLUSIONS

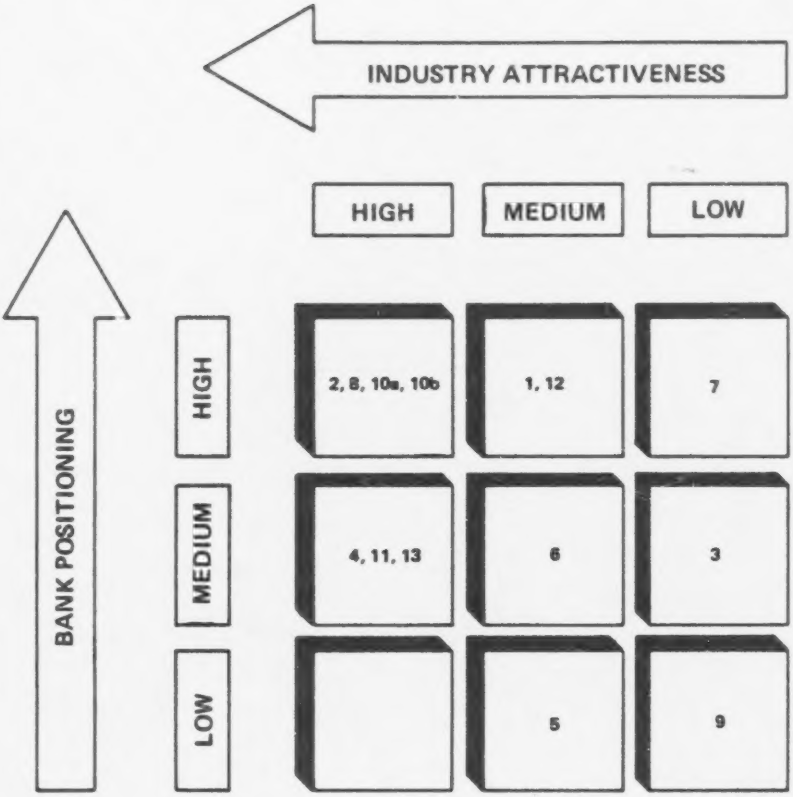
Phase I and Phase II results were combined to yield Exhibits V,VI, and VII, presented below. These exhibits display the market attractiveness/bank positioning results for each of the service markets studied for large, regional-medium and small banks. It was found that these three groupings are the most meaningful in terms of variances in positioning. Some differences were found between branch and unit environments, which apply primarily to the distribution system advantage. These were addressed in the individual analysis of each service market. No significant differences were found between medium and regional bank positioning.

Strong Bank Positioning/High Market Attractiveness

Three service markets offer significant opportunities for large banks and such banks are especially well positioned for entry. Community banks and regional banks are also well positioned to offer discount brokerage or insurance brokerage and take real estate equity positions.

- Securities Brokerage - Full Service. Securities brokerage is a highly attractive market, which offers high profitability (introducing firms are the most profitable of all services reviewed), low capital requirements, low risk and low critical mass. The industry is concentrated but few entry barriers exist and can be overcome. This fee income generator is a natural extension of bank services. Banks are well suited to offer securities brokerage, and the service allows them to capitalize on unique competitive advantages including: an extensive customer base; a strong physical distribution system; a strong image as the primary financial institution and financial services provider for most customers; and the natural fit between brokerage and other investment vehicles banks offer. Bank positioning to offer full service brokerage varies by size: the larger

EXHIBIT V
BANK POSITIONING/MARKET ATTRACTIVENESS MATRIX
LARGE BANKS



	HIGH	MEDIUM	LOW
HIGH	2, 8, 10a, 10b	1, 12	7
MEDIUM	4, 11, 13	6	3
LOW		5	9

KEY:

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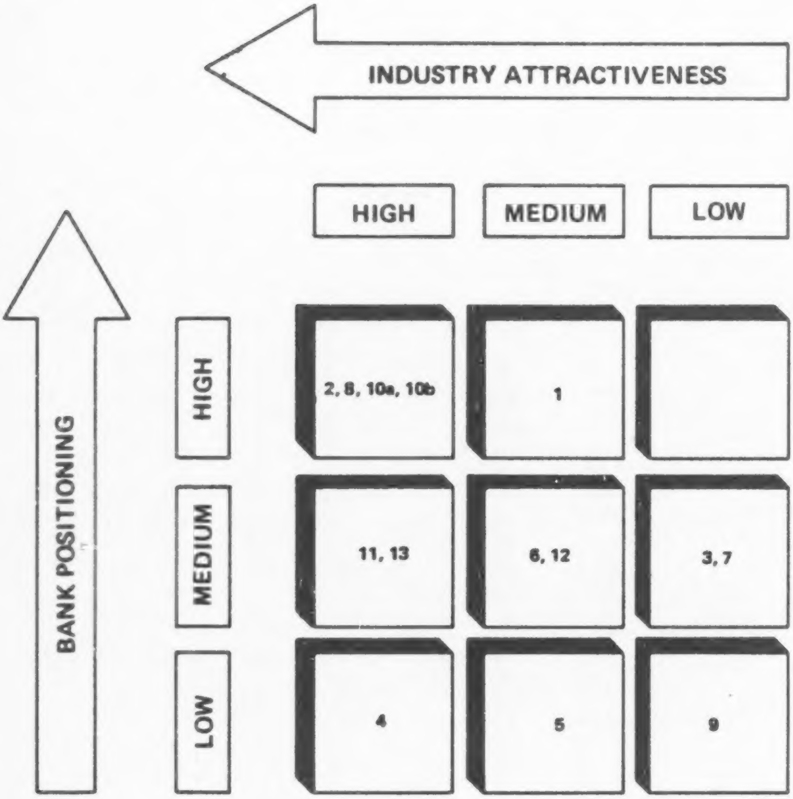
1. REAL ESTATE BROKERAGE
2. REAL ESTATE EQUITY
3. TRAVEL AGENCY
4. DATA PROCESSING
5. TELECOMMUNICATIONS
6. MANAGEMENT CONSULTING
7. NON-FULL PAYOUT LEASING
8. INSURANCE BROKERAGE
9. INSURANCE UNDERWRITING
10. SECURITIES BROKERAGE
    a. DISCOUNT
    b. FULL SERVICE
11. SECURITIES UNDERWRITING
12. MUTUAL FUND MANAGEMENT
13. COMMODITIES/FINANCIAL FUTURES BROKERAGE

EXHIBIT VI
BANK POSITIONING/MARKET ATTRACTIVENESS MATRIX
MID-SIZE BANKS

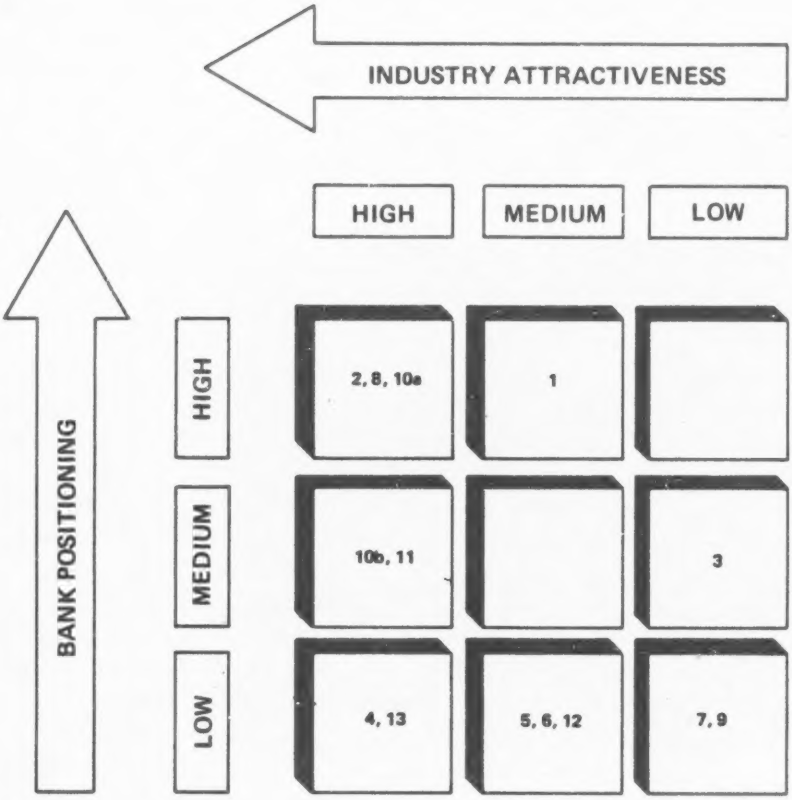


Bank Positioning \ Industry Attractiveness	HIGH	MEDIUM	LOW
HIGH	2, 8, 10a, 10b	1	
MEDIUM	11, 13	6, 12	3, 7
LOW	4	5	9

KEY:

1. REAL ESTATE BROKERAGE
2. REAL ESTATE EQUITY
3. TRAVEL AGENCY
4. DATA PROCESSING
5. TELECOMMUNICATIONS
6. MANAGEMENT CONSULTING
7. NON-FULL PAYOUT LEASING
8. INSURANCE BROKERAGE
9. INSURANCE UNDERWRITING
10. SECURITIES BROKERAGE
    a. DISCOUNT
    b. FULL SERVICE
11. SECURITIES UNDERWRITING
12. MUTUAL FUND MANAGEMENT
13. COMMODITIES/FINANCIAL FUTURES BROKERAGE

EXHIBIT VII
BANK POSITIONING/MARKET ATTRACTIVENESS MATRIX
SMALL BANKS



	HIGH	MEDIUM	LOW
HIGH	2, 8, 10a	1	
MEDIUM	10b, 11		3
LOW	4, 13	5, 6, 12	7, 9

KEY:

1. REAL ESTATE BROKERAGE
2. REAL ESTATE EQUITY
3. TRAVEL AGENCY
4. DATA PROCESSING
5. TELECOMMUNICATIONS
6. MANAGEMENT CONSULTING
7. NON-FULL PAYOUT LEASING
8. INSURANCE BROKERAGE
9. INSURANCE UNDERWRITING
10. SECURITIES BROKERAGE
    a. DISCOUNT
    b. FULL SERVICE
11. SECURITIES UNDERWRITING
12. MUTUAL FUND MANAGEMENT
13. COMMODITIES/FINANCIAL FUTURES BROKERAGE

the bank, the stronger the position. This is due to the skill intensity of the business. Large banks, particularly those with large trust departments and/or active trading portfolios, possess many of the required skills. They are better able to hire expensive expertise, although they must change their compensation schemes to retain brokers. Large banks are also better positioned to enter the market through acquisition. Smaller banks do not have the financial power and the market size required to support full service brokerage; the smaller the bank, the less capable it is to retain strong brokers and profitably employ them. Hence, smaller banks' positioning was ranked as medium.

- Discount Brokerage. This activity is similar to full service brokerage. However, discount brokerage may be less profitable due to lower commissions. Bank size is of little relevance in positioning to enter discount brokerage, which has fewer skill requirements than full service brokerage.

- Insurance Brokerage. Insurance brokerage is a low risk, low concentration, low capital, low critical mass, and low skill intensive service. It is profitable, although profitability is declining, and does not represent a growing market. Its attractiveness lies in low entry barriers, low risk and average profitability performance. This market attractiveness is combined with excellent bank positioning resulting from competitive edges for banks of all sizes: customer base transferability of all customer segments; ability to leverage distribution systems; and potentially lower overhead due to existing space and personnel which can be leveraged. Other advantages include high product synergism with bank services such as real estate lending and consumer loans and strong bank image.

Banks typically do not possess skills to offer the service, but low skill intensity makes this shortcoming less significant.

Strong synergism in several areas, coupled with industry attractiveness and high defensive needs, make insurance brokerage, like securities brokerage, a potentially important fee income service for commercial banks of all sizes.

- Real Estate Equity. This segment represents another attractive service market which banks of all sizes are equally well positioned to enter. Real estate equity can be highly profitable. Although risky, banks already assume similar risks in construction lending. Real estate equity is also cyclical, capital intensive and skill intensive. Consequently, despite high profitability, real estate equity was rated between medium and high attractiveness.

  The primary positioning variable is not size but expertise: banks with heavy involvement in construction finance are well suited to enter the market, since they often possess requisite expertise. Bank distribution networks and image are less relevant inputs for bank positioning. Thus skill leverage, overlapping customer base, and strong product fit make banks with a commercial real estate lending portfolio well positioned for market entry.

Medium to Low Bank Positioning/High Market Attractiveness

This group of services includes attractive markets where large banks enjoy medium positioning. Bank positioning in these service markets declines with bank size.

- Financial Futures Brokerage. This segment represents an attractive market. It is the fastest growing segment of the futures brokerage industry. It is highly concentrated, yet entry barriers are low and focus on skill requirements. Capital intensity, critical mass and risks are low. Large banks are reasonably well-positioned to enter this service market. Their commercial customer base is large enough to support this relatively specialized activity. Many banks are familiar with the market through their own hedging activities and can leverage this knowledge. Strong product synergism can augment customer relationships and better position the bank as the company's financial management and risk management advisor. Financial futures can also be applied in credit transactions.

Large banks still need to acquire the expensive expertise to offer quality advice in this market. They must also be able to modify their personnel policies to accommodate brokers. Due to lack of expertise, image handicap, and, in many cases, inflexible personnel policies, banks are less well positioned to offer futures brokerage than securities brokerage activities. The advantages to bank positioning decline as the bank size declines.

- Securities Underwriting. This attractive market is characterized by high entry barriers. High profitability is offset by low growth, cyclical nature, high concentration, high capital and skill intensity, high critical mass requirements and a closed distribution network. Consequently, despite high profitability, market attractiveness is classified as medium.

Only large banks are well-positioned to offer securities underwriting to large corporate clients. These banks can afford to acquire the expertise needed, buy their way into Wall Street distribution system or create their own, and amass the capital required. In so doing, they must create an alternative distribution system, leverage their corporate customer base and take advantage of high product synergism, since securities underwriting is another form of financing. Activity in this service market must be structured to avoid the numerous potential conflicts of interest.

Small banks cannot penetrate the large, highly competitive corporate securities underwriting market. They can, however, offer securities underwriting in their local markets to local public entities. The expertise required to perform this limited scope, limited risk activity is lower than full scale underwriting. Competition is also local, since issues are too small to attract regional or national attention. Thus, small banks are well positioned to underwrite public issues in their local markets.

Regional and medium-size banks cannot compete against Wall Street investment banks. However, they may be able to fill the regional underwriting gap created by the acquisition of regional investment bankers. This task is more difficult than that faced by the community bank due to competition and the greater skill complexity required. The above factors result in lower positioning of regional-medium banks, as reflected in the matrix.

- Data Processing. Data processing is an attractive market. It is characterized by low entry barriers, high growth, a non cyclical nature, and medium concentration. It is highly profitable. It also involves medium to high capital requirements, high skill intensity and, in some segments, significant critical mass. High obsolescence risk is another consideration which contributes to a medium rating for this service market.

Banks of all sizes are not particularly well positioned to enter this market. Banks must be data processing oriented and, in some segments, computer owners, to enter the market. The smaller the bank, the less likely such factors will be present, resulting in the lower bank positioning.

Commercial customers, particularly medium and small companies and other banks, provide a market for bank data processing services. Hence, larger banks will have greater customer transferability due to more extensive correspondent relationships. The branch network is immaterial for entry into this market. In contrast, bank non-innovative image is a liability. Product synergisms exist for banks of all sizes, but skill fit is typically better at larger banks with greater resources and commitment to automation.

Data processing entry is not motivated by defensive considerations. Thus, it is evaluated more on the basis of skill fit and synergism, resulting in medium-low to low positioning.

The software and professional services segments of the industry appear to offer more profitability potential and less capital and critical mass requirements. These segments are more attractive, due to banks' ability to leverage existing skill or software packages developed for internal use. Internal capabilities are sunk costs essential for bank operations. Any possible leverage involves negligible marginal costs.

Strong Bank Positioning/Medium Market Attractiveness

Only one service market provides medium attractiveness and high bank positioning across all three groups - real estate brokerage. Mutual fund management is a medium attractive market for which large banks are well-positioned to enter, but small and medium ones are not.

- Real Estate Brokerage. All brokerage activities are attractive as fee generators and as non-capital or risk-intensive. Real estate brokerage is no exception: this is a low risk, low capital, low concentration, low critical mass business. Skill intensity is also low. However, the market is cyclical, growth potential is low, and profitability is average. Hence, market attractiveness was assessed as medium.

Bank positioning to offer the service is strong for banks of all sizes, particularly small banks. Banks can market real estate brokerage to both retail and commercial customers. Small banks are best positioned to do so since customer contact may be more frequent than in large banks and retail customer relationships are stronger. Banks can use their branches to sell real estate brokerage and can maintain listings on bank computer facilities, thus leveraging existing overhead to yield higher profitability than a non-bank real estate agency which bears all overhead. Bank image as a professional institution is an asset and product synergism and defensive needs are high. Banks are not skilled in the business, but this is a minor disadvantage in this low skill intensity market.

Mutual Funds. Mutual funds have shown rapid growth. Despite predictions of contraction, mutual funds are highly profitable, non-cyclical, and offer significant potential for fund management.

High skill intensity and high critical mass requirements preclude all but larger banks from profitable fund management, as reflected by positioning on the matrix. Many large banks already operate mutual funds and can capitalize upon existing skill, distribution network, and their customer base to exceed critical mass requirements. Some medium size banks can manage funds as well. Most small banks cannot amass the resources to offer a separate fund or family of funds. Bank consortiums may allow smaller banks to address this problem.

Mutual funds are a natural extension of bank deposit products. Although the defensive motivation for offering mutual funds has lessened with introduction of the new money market account, fund management still offers potential profitability and low risk potential to many large banks and some other banks or bank groups.

Medium to Low Bank Positioning/Medium to Low Market Attractiveness

Management consulting, telecommunications and non-full payout leasing are three areas which offer medium opportunities for entry.

- Management Consulting is a cyclical, highly concentrated, low growth, high skill service. It is not capital intensive, presents low risk, with profitability not related to firm size. These mixed characteristics are summarized in medium attractiveness. Tax advisory services have similar features.

  Bank positioning for entry into management consulting ranges from medium for large banks to low for small banks. The critical variable in successful consulting is skill. Larger banks typically possess greater specialized skill or knowledge which could be sold for a fee. Some product synergisms, particularly with financial management or tax advisory services, can be produced. Where banks have specialized skill, they can attempt to leverage it by marketing to their commercial (management consulting) and retail (tax advisory services) customers. Stronger synergism exists in tax services, which present significantly better potential for small banks than management consulting.

  Management consulting is not needed for defensive purposes. It can be profitable but requires skilled, experienced personnel. It can, however, be used to augment customer relationships (in wholesale) and cross-sell other bank products (e.g., tax advice - IRA account).

- Telecommunications is a high growth industry. It is highly capital and skill intensive, and requires high critical mass. Consequently, despite defensive motivation for entry, most banks are excluded from this market as information providers and as common carriers. Low product and skill synergisms make this even less attractive from a bank positioning perspective.

- Non-full Payout Leasing is a medium to low attractiveness market. Despite high profitability, many market segments are concentrated, entry is capital intensive, and credit risks, capital risks and residual risks are extensive.

  Large banks are well positioned to offer the service. They typically have access to capital intensive industries which is a key requirement for success. They will also have the capital needed to finance airplane and box car transactions. They can hire residual risk managers and have strong leasing expertise.

  Regional-medium bank positioning is not significantly different from the large banks. Small banks, however, are precluded from most non-full payout leasing by transaction size. Agricultural equipment is an attractive market for them; yet, the residual risk may be too high for most small bank risk thresholds.

  Non-full payout leasing is not motivated by significant defensive reasons, since banks can offer leasing arrangements today. In this particular segment, key competitors are outside the financial services industry.

Medium to Low Bank Position/Low Market Attractiveness

Insurance underwriting and travel agency are two markets which present little opportunity for profitable bank entry.

- Insurance Underwriting is a low profitability, high risk, high critical mass, skill intensive, cyclical, non-growth market. It is not an attractive market to enter. Reinsurance is one entry mode which alleviates some risk; nonetheless, profitability is low.

  Banks are not well positioned to enter the business, as they lack the expertise, knowledge, and product synergism. It may negatively affect their image. It appears that banks' competitive advantages will not be capitalized upon in this service market. Narrow market segments, such as annuities, may provide better potential and stronger synergism, and should be evaluated. However, most banks will be precluded from entry by high capital intensity and critical mass requirements.

- Travel Agency. This market has low entry barriers, low capital intensity, low critical mass, and low skill requirements. However, profitability is also low and is expected to decline further if protective regulations are revised. Banks could enter the market through their customer base, both commercial and retail, and use the existing distribution network. However, product synergism is limited and necessary skills although minor, will have to be acquired.

  Thus, although banks are reasonably well positioned to enter the market, it does not appear to offer significant opportunities.

Service Market Linkages

This study focused primarily on the independent potential of each service market. In the banking industry, linkages between services are of critical importance. Individual financial services are best marketed in groups. Synergies between certain service markets are discussed at greater length in individual service market reports. Examples of "product clusters" consisting of a number of grouped service markets include:

- Full service real estate. A full service bank real estate department could offer real estate development services, property management, real estate syndications, property/casualty insurance and real estate brokerage services in addition to real estate financing and escrow accounts to both retail and commercial customers. Ability to bundle these services increases customer convenience and allows a bank to maintain customer contact through each transaction involving real estate. Full service real estate activities would produce additional fee income and offer opportunities for cross-selling. Real estate product clusters also position a bank to more effectively meet non-banking competition.

- Fund placement. Securities, mutual funds, real estate investments, commodities or financial futures, insurance annuities and bank deposits are alternative investment vehicles with varying liquidity, yield and risk. Banks that can offer this full range of fund placement opportunities for retail or commercial customers are at an advantage with respect to non-bank competitors. In addition, bank customers receive convenient access to a wide variety of investment opportunities.

- Vertical integration. Banks that broker insurance, mutual funds or securities may have opportunities for increased profits associated with insurance underwriting, mutual fund management or securities underwriting. These combinations may produce operational efficiencies and further cover bank overhead.

- Personal financial services. A complete package of personal financial services includes alternative vehicles for fund placement, personal lending, financial advice, and insurance for health, life or possessions. Product clusters permit banks to augment customer relationships while offering the fullest level of service.

- Corporate financial services. A complete package of services for commercial clients can include management consulting, data processing, alternative vehicles for fund placement, and alternative sources of financing such as leasing, securities underwriting, and traditional lending products.

In summary, the reason for considering individual service market entry may well transcend bank positioning and market attractiveness. Entry into a service market or group of service markets will facilitate commercial banks' transition into profitable full service financial institutions. Without such transition, banks will not be able to retain their position as the primary financial institution for their customers by the end of the decade, when the homogenization of the financial services industry in the United States is well underway.

NBI ID SHEET

JOB NO.	R5973
SECTION NO.	I
ID NO.	5973CHART
PROJECT NAME	ABA-CHART
MANAGER	BROTHERS
EXTENSION	7172
DEADLINE	1/27/83 - 1/28/83
CHARGE NO.	061-61430-710
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LEVEL OF COMPLEXITY	[ ]
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APPENDIX

PERMISSIBILITY OF PROPOSED NATIONAL BANK ACTIVITIES

Note: This table is intended only to provide a regulatory overview overview and is not a legal opinion of what is permissible.

Proposed Activity	General Prohibition/Authorization	Exceptions
Securities Brokerage and Underwriting/ Financial and Commodities Futures Brokerage	May only buy or sell securities for customers and upon their request, may not underwrite securities or deal in securities.	May deal in or underwrite obligations of the various federal government and general obligations of state and municipal government entities, within statutory limits. However, affiliation with brokers or underwriters who do more than this is impermissible.
Insurance Brokerage and Underwriting	May not act as agents for any fire, life, or other insurance company in any place the population of which does not exceed 5,000. May also endorse, guaranty, or indemnify obligations.	May sell credit life and health insurance.
Commodities Brokerage	Impermissible.	May take commodity in form of warehouse receipts or bill of lading as security for obligation.
Mutual Funds	Impermissible.	May manage individual agency and collectively invest trust fund accounts.
Real Estate Brokerage and Equity	May act as real estate broker or agent.	May purchase, hold, and convey real estate only if it is: required for their business, mortgaged to them, conveyed in satisfaction of a debt, or purchased at sale pursuant to their mortgage. May also engage in equity sharing type real estate loans where principal is not at risk.
Data Processing/Telecommunications	May use data processing or telecommunications equipment to perform for itself and others all services expressly or incidentally authorized under statutes applicable to national banks.	May not require any proposed customer to utilize any data processing service offered.
Non-Full Payout Leasing	May become the legal or beneficial owner and lessor of specific personal property at the request of the lessee or in connection with a pre-existing lease.	Lease must be net, full-payout, non-cancellable type wherein the bank accepts minimal maintenance and service responsibilities and fully expects to receive a full return of its investment plus costs of financing.
Travel Agency	Full scale operation of a travel agency is impermissible. Cannot operate or promote tours, or arrange accommodations or transportation.	
Management Consulting (including Tax Advisory)	May provide bank consulting services only, including: new bank feasibility studies, cost analyses, merger and acquisition analyses, personnel and operations reviews, market development and advertising studies, marketing operation analyses, and capital adequacy evaluation.	
Securities Brokerage and Underwriting	May not sponsor, organize, or control a closed-end investment company. May own discount brokerage and undertake private placements.	

PERMISSIBILITY OF PROPOSED BANK HOLDING COMPANY ACTIVITIES

Note: This table is intended only to provide a regulatory overview and is not a legal opinion of what is permissible.

Proposed Activity	General Prohibition/Authorization[1]	Exceptions
Insurance Brokerage and Underwriting	May sell credit life, disability, and involuntary unemployment insurance. May undertake general insurance activities in towns of less than 5,000 upon showing that existing facilities are inadequate. Bank holding companies with assets of less than $50 million may undertake a more general range of insurance activities.	May not engage in sale of mutual fund shares and life insurance policies as a package (commonly referred to as insurance premium funding), also may not engage in sale of level-term life insurance or underwrite real estate mortgage guarantee insurance. May not underwrite property, casualty, or home life mortgage insurance.
Commodities/Financial Futures Brokerage	No prohibition, may be permissible.	
Mutual Funds	May not sponsor, organize, or control a mutual fund. May advise an open or closed-end fund and may distribute for a closed-end fund.	
Real Estate Brokerage and Equity	May not engage in real estate brokerage, agency, or syndication. May not engage in land development or property management.	May make equity and debt investments in corporations or projects designed primarily to promote community welfare and may act as real estate appraiser. May manage own property and property held in fiduciary capacity or acquired through default on loan.
Data Processing/Telecommunications	May provide data processing and transmission services for financial, banking, and economic data.	
Non-Full Payout Leasing	Similar to National Banks.	
Travel Agency	May not sponsor, organize, or control travel agency.	
Management Consulting (including Tax Advisory Services)	May not engage in general management consulting.	Allowed for depository institutions within statutory limits.

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[1] Section 4(c)(5) of the 1970 Amendments to the Bank Holding Company Act gives BHC's all express and incidental powers of national banks granted by the Glass-Steagall Act. Other statutes and case law that give those powers to BHC's are cited where appropriate.

APPENDIX B

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APPENDIX C

SUMMARY OF FDIC AND ABA TASK FORCE POSITIONS ON DEPOSIT INSURANCE

Risk Sharing

ABA Task Force Interpretation of FDIC Position

- The current deposit insurance system has worked well so far. However, liberalization of deposit rate ceilings and entry and product restraints could result in greater risk and more bank failures.
- The FDIC would like to adopt a system of risk sharing with bank creditors and uninsured depositors. This could be done by allowing purchase and assumption transactions which impose a portion of the loss on bank creditors and large depositors. These large depositors would then help discipline banks by moving funds from banks that took excessive risks.
- Without such risk sharing the FDIC would have to increase its examination efforts to evaluate the increased risk.

Task Force Position

- The Task Force doesn't object in principle to changing legislation to permit the FDIC to share risk with large depositors in a purchase and assumption, an assistance transaction, or a merger.

Increased Disclosure

ABA Task Force Interpretation of FDIC Position

- For risk sharing to be successful, large depositors need to be able to evaluate risks they incur. Large depositors need more information than is currently available to do this.
- Release of additional information will not harm banks. For example, information on non-performing loans has been available for large banks for years, and it hasn't been a problem; therefore, it should not be a big problem for small banks who are likely to be subjected to much less scrutiny partly because most of their depositors are insured.
- Isaac suggested that FDIC could publish a list of information that intelligent creditors ought to know, and then leave it to the creditors to ask their bank for the data.

Task Force Position

- The Task Force does not believe that increased mandatory disclosure will lead to more efficient risk sharing. Increased disclosure puts an additional burden on the banks providing the information. In addition, release of some information could be counterproductive.

- A lot of data is already available, but is not used. If there is a change in legislation to permit a purchase and assumption/assistance transaction which shares losses with large depositors, this data will be used more intensively. If the market demands more data, let them tell us what is needed and when.

- Increased disclosure will make the examination process become increasingly adversarial, which will be bad for the FDIC and the banking system.

- Examination has helped many troubled banks to recover; this will be less likely with increased disclosure.

- Much more study is needed to determine how to measure some key things, like interest rate risk.

- FDIC publishing a suggested list of data relevant to evaluating a bank may be a workable alternative (actual disclosure would be voluntary). However, the Task Force would not support this alternative until seeing the list of data that the FDIC would consider relevant.

Private Insurance

ABA Task Force Interpretation of FDIC Position

- Sharing risk with large depositors may create a demand for private deposit insurance. Should the FDIC promote the growth of private insurance?

Task Force Position

- The FDIC should not orchestrate private insurance; if the market demands it, the needs will be met.

- The Task Force does not perceive a significant or growing demand for increased FDIC or private sector insurance at this time. The development of private sector insurance depends on its cost relative to the cost of other forms of protection. If such insurance develops, its cost is likely to vary and it may not be available to all banks. Consequently, there might have to be an insurer of last resort. This would probably be the FDIC, which would end up insuring the highest risk banks while private insurers insured low risk banks.

- The Task Force is concerned that marketing techniques of private insurance companies might be a problem. In addition, cancellations might be arbitrary and disruptive. Such problems could lead to a need for federal regulation.

- Private insurance may be more costly and less effective than FDIC insurance because of the psychological advantage of the FDIC that private insurers cannot match.
- Banks should not offer excess deposit insurance coverage to other banks, because the linkage of risks would be too great.

Risk Based Insurance Premiums

ABA Task Force Interpretation of FDIC Position

- The FDIC believes that risk based premiums would reduce the inequities of the current flat rate system and would provide an incentive for good management.
- The FDIC also believes that risk based premiums would allow merger of the insurance funds which would facilitate inter-industry mergers and decrease some administrative costs.

Task Force Position

- The Task Force agrees that risk based premiums could, in principle, provide some important benefits. However, the Task Force is opposed to them because of the near impossibility of accurately assessing risk.
- The Task Force suggested the possibility of charging for any additional examinations the FDIC deems necessary to monitor high risk or problem banks. This would, in effect, be a type of risk related premium.
- The Task Force is strongly opposed to a merger of the insurance funds, i.e. FDIC and FSLIC.

APPENDIX D

ISSUE: AMENDMENTS TO THE FINANCIAL INSTITUTIONS REGULATORY ACT OF 1978 (FIRA)

In October 1978, FIRA was enacted, setting limits on a bank's ability to deal with its directors, officers, and employees in certain credit-related areas, and imposing significant, new burdens on banks and their management officials in several areas. Because the provisions of the bill impose burdens on bank management out of all proportion to the purposes of the bill, a number of amendments are being sought by the Association to correct inequities in the legislation.

Among the major provisions of the amendments are:

1. Committees of boards of directors should be permitted to act on loan applications and board approvals could be made after loan consummation when necessary rather than in advance by the entire board of directors;

2. The individual borrower limits applicable to State chartered banks should apply to aggregate loans to bank management officials and their controlled companies or their political campaign committees, rather than the single borrower limits of the National Bank Act;

3. Extensions of credit to subsidiaries of insured banks and bank holding companies without the prior approval requirements of the act should be authorized. Such loans would continue to be subject to the requirements of Section 23(A) of the Federal Reserve Act;

4. While Section 110 of the Act was amended as part of the Garn-St Germain Depository Institutions Act to permit mortgage loans and educational loans without dollar limits, potential increases in the limits on other personal loans for member banks executive officers, loans secured by deposits in excess of the amount of the loans should also be permitted without limit;

5. A new subsection should be added to the Change in Bank Control Act to provide that whenever the primary supervisory agency of an insured bank is a State banking authority, the approval or lack of disapproval of a proposed acquisition by the State supervisor under State law similar to Title VI, shall preempt any requirement of notice and the opportunity to disapprove by the appropriate Federal supervisory agency;

6. Titles VIII and IX on reporting of loans to management officials should be deleted because they have already been shown to be ineffective, duplicative of other record keeping requirements, and extremely onerous for the individuals and banks required to make the reports.

The Association has already drafted legislative language to accomplish these amendments. In addition, the bank regulatory agencies have submitted to Congress a package of legislative amendments that embodies most of ABA's recommendations. These amendments were included in the Senate-passed version of the Depository Institutions Act last year, but, unfortunately, did not finally pass.

APPENDIX E

ISSUE: SIMPLIFICATION OF THE ELECTRONIC FUND TRANSFER ACT

The initial versions of the EFT Act were introduced in Congress in the fall of 1977. The American Bankers Association vigorously opposed this legislation, stating that it was premature, unnecessary and would inhibit the future development of electronic banking services. The Act was passed in October 1978 as a title of FIRA. The Federal Reserve implemented the Act, which became effective on May 10, 1980, through the promulgation of Regulation E. The Association strongly supports legislation which would reduce the compliance burdens imposed by the Electronic Fund Transfer Act.

Congress should enact amendments to the EFT Act which would ease the burden of financial institutions in complying with the Act's requirements, thus enabling the offering of more efficient and less costly EFT services to consumers, without sacrificing significant consumer protections. Specifically, we urge Congress to:

- give the Federal Reserve Board greater discretion in modifying statutory requirements when it demonstrates that the compliance costs outweigh the consumer protections provided;
- deem model clauses as complying with state plain language requirements;
- provide a uniform effective date for compliance with regulatory changes;
- reduce the amount of required initial disclosures to truly important information;
- eliminate frequency requirements for periodic statements;
- reduce the number of required disclosures on periodic statements;
- require that consumers provide written notice of asserted errors;
- extend the period of time available to an institution to complete an investigation of an error before it must provisionally recredit the account;
- delete the treble damages provisions for certain violations of the error resolution provisions;
- provide a negligence standard for consumer liability in lieu of the current three tier liability scheme;
- delete the mandatory statutory damages from the civil liability provisions; and,
- provide for a full federal preemption of state EFT consumer protection legislation.

Section 904 REGULATIONS

The Federal Reserve is mandated by the EFT Act to prepare an economic impact analysis of its implementing regulations, taking into consideration the cost and benefits to financial institutions, consumers, and other users of electronic fund transfers. It must also, "to the extent practicable, ...demonstrate that the consumer protections of the proposed regulations outweigh the compliance costs imposed upon consumers and financial institutions." Unfortunately, the Board is not given the necessary flexibility to modify the Act's requirements if it determines that the costs of compliance outweigh the consumer protections provided. We believe that this flexibility must be incorporated into the Act.

Section 904(b) of the Act requires the Federal Reserve to issue optional model clauses for use by institutions to facilitate compliance with the Act's disclosure requirements. However, financial institutions in states which have enacted plain language statutes may not be able to avail themselves of the Federal Reserve's model language. Since the Act currently requires that the model clauses be in "readily understandable language," it should also state that use of the model clauses constitutes compliance with state plain language requirements.

Congress should also adopt a concept similar to that found in the amended Truth in Lending Act, and state that any regulation of the Board, or any amendment or interpretation thereof, becomes effective on that October 1 which follows by at least six months the date of promulgation. However, any financial institution should be allowed to comply with any newly promulgated requirements prior to the effective date of the requirements. This would ensure that institutions would not be forced to make costly systems or disclosure changes more frequently thatn once per year.

Section 905 TERMS AND CONDITIONS OF TRANSFERS

In the realm of consumer legislation, the presumption is typically made that the amount of disclosures given to consumers is directly proportional to the resulting level of consumer protection. It is time for Congress to reevaluate this notion. In practice , the greater the amount of information edisclosed to the consumer, the lesser the probability that the consumer will take the time to read the disclosure at all. Therefore, it is often true that excessive disclosures actually lead to a lower level of consumer knowledge and awareness of the terms ofthe service being described. The American Bankers Association strongly believes that consumers will ultimately be better informed if only the most important terms are disclosed.

The current disclosure requirements of Section 905 clearly result in "information overload" for the consumer. These disclosures are seldom read, and therefore fail to serve their intended purpose. Since the majority of the disclsoures do not provide necessary information to consumers, the appropriateness of requiring all of these disclosure terms should be reevaluated. Also, given the fact that most consumers do not keep their initial disclosures for future reference, Congress should consider changing the timing of particular disclosures so that they become more useful to consumers.

Section 906 DOCUMENTATION OF TRANSFERS; PERIODIC STATEMENTS

There is no need to legislatively mandate that receipts of terminal transactions be made available to consumers at the time of the transaction. Electronic banking is very competitive; if terminal receipt capability affects an institution's standing in the marketplace or promotes consumer acceptance, the institution will provide that capability, absent any statutory requirement to do so. The Act should state that a consumer who has not received documentation evidencing a terminal transaction (for example, at the time of the transaction or subsequently on a periodic statement) has the right to request written evidence of the transaction, if it is needed for tax purposes or to resolve a dispute with a third person.

This approach would ensure that consumers would have access to this documentation when necessary, without inhibiting the development of innovative EFT services and would be in keeping with the specific Congressional intent of not imposing receipt requirements "where the expense of providing a receipt would nullify the cost savings of these services."

The Act's frequency requirement for periodic statements has had an adverse impact on many consumers without providing commensurate consumer protections. As a result of this costly requirement, many consumers have been faced with a decrease in available EFT services or increased account charges. Savings accounts have been particularly hard hit by this requirement.

This is an excellent example of Congress enacting a solution for which there was no problem. There has been no need to regulate the statement frequency for traditional deposit accounts; the introduction of electronic fund transfers to and from these accounts does not create such a need. Consumers have a wide and ever expanding array of deposit services available to them in the marketplace. They should be permitted to make the judgment of what level of service and corresponding charges best suits their particular needs. By choosing more infrequent statements, consumers would not be sacrificing any of their protections under the Act. For example, consumers would still have 60 days from the transmittal of a statement first reflecting an error to notify the institution of that error. This right does not hinge on how frequently the statements are provided.

Since the frequency requirement imposes significant costs on financial institutions, as well as some consumers, without providing equivalent benefits to consumers, we urge the Congress to delete this requirement from the Act.

Congress should also reexamine the necessity of legislating the informational content of statements to the extent it has done so in the current Act. Required disclosure of information should be deleted from the Act if (1) it will be provided by institutions regardless of statutory requirements (e.g., fees and charges, beginning and ending balance, account number) or (2) the cost of providing the information far exceeds the benefits derived by consumer (e.g., descriptive location of terminal). Other statement requirements can be simplified. For example, institutions should be permitted to disclose a telephone number for errors and inquiries, and the time period within which the consumer must notify the institution of an error, in lieu of explaining the actual resolution procedures. Many of the specific disclosure requirements for terminal receipts and periodic statements will certainly impose unnecessary additional cost on financial institutions as the number and size of shared systems increases.

Section 908 ERROR RESOLUTION

In order to be subject to the Act's error resolution procedures, a consumer should be required to provide written notification of an error. This would greatly facilitate the institution's ability to promptly investigate and resolve the error. A written explanation is most often more clear and concise than an oral conversation. The consumer probably looks into the problem more carefully before submitting a written notice of error, and may discover on his own that there was, in fact, no error.

There is no evidence of consumer dissatisfaction with the written notice requirement in the Fair Credit Billing Act. As a matter of bank practice many notices of credit billing errors are received orally, outside the scope of the regulation. Many of these inquiries are resolved during the initial conversation. However, assertions which require further investigation are usually required to be given in writing. A written notice rule would also simplify resolution of EFT errors for institutions, and should be adopted.

The resolution procedures themselves are extremely complex, especially if the account must be provisionally recredited. Provisionally recrediting an account exposes the institution to substantial risk, since the consumer has full use of the recredited funds prior to the conclusion of the investigation. An adequate period should be provided prior to required provisionsl recrediting within which the institution can resolve most error assertions, which would also not greatly inconvenience consumers. The ten business day period provided in the Act is not adequate, and should be lengthened.

Section 908(e) of the Act provides onerous treble damage penalties for certain violations of the error resolution procedures. This provision is unwarranted. All violations of the error resolution section should be handled solely by the 915 civil liability provisions.

Section 909 CONSUMER LIABILITY FOR UNAUTHORIZED TRANSFERS

The current statutory rules for determining consumer liability for unauthorized transfers are both complex and extremely difficult to apply. The act sets a $50 maximum liability if a consumer notifies the institution within two business days of learning of a loss or theft of an access device. The consumer becomes liable for a maximum of $500 if the loss is not reported within the two business day time frame. The consumer is liable for any losses which occur after 60 days of transmittal of a periodic statement reflecting an unauthorized use. Needless to say, it is virtually impossible in many cases for the institution to determine when a consumer learned of a particular loss. Even if institutions were able to make this determination, the resulting liability imposed on different consumers appears inconsistent — for example, consumers who do not examine their periodic statements and never notice that their card has been lost or stolen may be subject to a lesser liability than consumers who quickly discover the loss of their EFT card but forget to notify the institution until three business days later.

However, we believe the major failing of the current standards is that losses due to substantial consumer negligence are treated in the same manner as losses over which the consumer had no control. We urge Congress to revise the Act's liability scheme to provide for a more equitable distribution of risk. The consumer should have no liability for unauthorized transfers, unless the financial institution can prove fraud or negligence. When fraud or negligence is proven, there should be no limit on the consumer's liability. The standard for negligence should include:

1. writing the personal identification code on the access card;
2. voluntarily permitting the access devices (e.g., the PIN and card) to come into the possession of a person who makes or causes to be made an unauthorized use;
3. failure to report the loss of an access device to the card issuer within a reasonable period of time; or
4. failure to report an unauthorized use appearing on a statement within a reasonable period of time after the receipt of that statement.

This would provide a more equitable allocation of risk between the customer and the institution. It places the risk of most losses upon the financial institution, particularly those which cannot be avoided by the consumer. On the other hand, it places on the blatantly careless consumer the risk of loss from his own gross negligence. The National Commission on Electronic Fund Transfers, after lengthy study of this issue, also recommended to Congress that a negligence stardard be used in determining the consumer's liability for unauthorized transfers (EFT in the United States: Policy Recommendations and the Public Interest; October 28, 1977).

Section 915 CIVIL LIABILITY

The civil liability provisions should be amended to delete the mandatory statutory damages, and substitute a punitive damages scheme similar to that of the 1976 Equal Credit Opportunity Act. As experience with Truth in Lending has indicated, a mandatory minimum statutory recovery encourages frivolous litigation arising from technical violations of the Act in which no actual damages can be shown.

Section 919 RELATION TO STATE LAWS

The Electronic Fund Transfer Act is a very comprehensive statute, providing a wide range of consumer protections. Since the current Act, and an amended Act incorporating the amendments we are recommending, provide a sufficient level of protection for consumers, we believe that a full federal preemption of state EFT consumer protection legislation is warranted. Allowing a patchwork of state EFT requirements to coexist with the Federal law would substantially reduce the benefits both financial institutions and consumers could derive from simplification legislation.

Overlapping federal and state laws are particularly problematic for institutions operating multi-state EFT networks. Financial institutions should not be subject to a variety of differing state laws on subjects which the federal government has already established adequate rules of protection.

Therefore, the American Bankers Association supports the full federal preemption in the area of EFT consumer protection legislation, since the federal government has already legislated in a comprehensive manner. This is the only practical long-run solution to the current situation.

The comments and recommendations made above are intended only to highlight the need for revision of the Electronic Fund Transfer Act, and certainly do not constitute a comprehensive list of changes which ought to be made. We believe that consumers would benefit from the reduction of many of the regulatory burdens associated with providing electronic banking services. Such a reduction would allow for the development of more varied and innovative service choices for consumers at a lesser cost than would be otherwise available.

We would welcome the opportunity to work with the Committee to that end.

APPENDIX F

April 4, 1983

ABA TASK FORCE ON RESTRUCTURING THE FEDERAL FINANCIAL REGULATORY AGENCIES
RESPONSE TO
THE TASK GROUP ON REGULATION OF FINANCIAL SERVICES

Criteria for Judging Proposals to Change The Regulatory System for Financial Institutions

Preamble

The essential purpose of financial institution regulation is to ensure that our financial system serves the broad public interest with maximum effectiveness. The definition of the public interest should start with the needs of the customers of financial institutions. All proposals for change should be judged by whether they improve the ability of well-managed financial institutions, regardless of size, to meet their customers' needs effectively and profitably. Changes that increase competition among privately-owned providers of financial services and that reduce regulatory burdens that hinder the efficient provision of services will improve the financial system's ability to meet customer needs.

FUNCTIONAL CRITERIA

1. A major goal of regulation should be to assure the safety and soundness of the financial system in order to (a) protect depositors against loss up to a certain limit; (b) limit the secondary effects of depository institution failures; and (c) provide maximum opportunity for the workings of market incentives and disciplines.

2. Regulation should become function-oriented, and there should be uniformity of regulation for all functions performed by whatever organizations.

   a. Regulatory burdens should be minimized, and the responsiveness of regulatory agencies in reviewing and approving proposed actions by institutions should be improved substantially.

   b. Disparities in regulation of the same functions or activities should be eliminated regardless of what organization, financial or otherwise, performs the activity.

   c. The regulatory structure and processes should provide clearly for due process.

   d. Consumer regulation should be managed in a manner consistent with the objective of reducing regulatory burdens. If regulation is deemed necessary, then it should be imposed equally on all providers of the same services. Non-bank subsidiaries should be regulated by the same agency, if any, as would regulate competitive organizations performing the same functions.

3. Disclosure requirements for banks should be consistent with the goal of assuring the safety and soundness of the financial system. Increased SEC disclosure requirements for non-bank subsidiaries and bank holding companies have, on balance, proved beneficial to the public and to the institutions involved. However, since the effect of increased public disclosure of operating data by smaller financial institutions is unknown, this question requires further extensive study, particularly in view of the risks of misinterpretation of data by the public and/or the news media.

4. Needless duplication of examinations and regulatory activities at the Federal level and between Federal and state agencies should be eliminated.

STRUCTURAL CRITERIA

Recognizing the important and continuing role of states in the regulation of financial institutions, any change or restructuring of the Federal regulatory agencies should not diminish the benefits derived by the public from the dual banking system.

1. The functions of deposit insurance agencies should be limited to those necessary for the protection of deposits and the safeguarding of the deposit insurance funds. Moreover, the structure of deposit insurance coverage may need to be altered to provide all depositors equal deposit insurance coverage. The same options for the recovery of funds deposited in a failed institution should be available whether the closed institution is merged with another or depositors are paid off.

To prevent the impact on the total banking system of the closing of any very large institution from carrying dangerous economic consequences, all demand deposit accounts should be fully insured. All small depositors should also be fully protected, while large, sophisticated depositors may be expected to bear some risk of loss in order to exert marketplace discipline on depository institutions. It is vital that all depository institutions have identical deposit insurance coverage.

2. The present structure for the implementation of monetary policy should be maintained and strengthened. To that end, the Federal Reserve System's regulatory role should be focused strictly on monetary policy formulation and implementation, through elimination of the burden of regulatory and

supervisory responsibilities not necessary to the conduct of monetary policy. However, in no case should the System be denied the authority to gain the information it needs from all types of financial intermediaries to formulate and implement monetary policy.

3. Consistent with the objective of sound supervision and regulation, any agency that charters and supervises depository institutions should be independent of political control. Any other approach risks confusion of political and regulatory objectives.

4. Government agencies should be prohibited from competing with the private sector in providing financial services where the private sector is able and willing to meet the need for such services. Where they are permitted to provide financial services, Federal agencies should take care not to use their powers as regulators or operators of nationwide systems to compete unfairly with the private sector.

5. Any restructuring of financial institution regulation should recognize the need for effective communication among the financial regulatory agencies, the insuring agencies, the Federal Reserve and other government agencies, including those responsible for international financial policy and U.S. foreign policy.

6. Quality regulation demands quality people. Compensation systems should be structured accordingly, perhaps by exempting financial institution regulatory agencies from the pay scales of the Office of Personnal Management.

Appendix G

Truth In Lending

The four following changes are urged as needed reforms to reduce the burden of compliance with Truth in Lending:

- o Revising the civil penalties structure in Truth in Lending to eliminate statutory penalties entirely unless the creditor's forms and procedures are in "substantial noncompliance" with the law.
- o Exempting all purchase money mortgage loans from the law or, as an alternative, simplifying and integrating Truth in Lending requirements in RESPA disclosure requirements.
- o Implementation of a better standard for resolving conflicts between federal Truth in Lending law and similar state disclosure laws.
- o Eliminating the right of rescission in loan situations not involving a sale of goods or services.

We also draw the Committee's attention to two provisions with impending expiration dates. These provisions need to be made permanent:

On February 27, 1984 the present prohibition in Section 167 of the Truth in Lending law on imposition of credit card surcharges will expire. The Association urges this Committee to make this surcharge prohibition permanent. The expiration of this provision would result in consumer confusion between cash discounts and credit surcharges and will make comparison shopping impossible. Such a result would negate the purpose of the Truth in Lending law, which is to provide an understandable means of determining the cost of credit.

Section 125 of the law pertains to a consumer's 3 day right to rescind a transaction involving a security interest in the consumer's principle dwelling. This provision contains an exception to the notice requirement and rescission right for advances under a pre-existing open-end credit plan (charge card or line of credit) if the security interest had previously been acquired and the customer had received notice of the right to rescind at the time the credit plan was agreed upon. This exception will expire on October 1, 1985. While action to extend this deadline or make the exemption permanent could come in the 99th Congress, creditors cannot enter into these arrangements with confidence in their continued validity until this exemption is made permanent.

APPENDIX H

STATEMENT ON THE BUDGET
ECONOMIC ADVISORY COMMITTEE
FEBRUARY 1983

The Administration has based its economic program on four main elements: reductions in the rate of growth of government spending and taxes, monetary policy designed to reduce inflation and a program to reduce the regulatory burden on businesses and individuals. The first two elements directly influence the budget. Reductions in taxes were carried out through the Economic Recovery Tax Act in 1981. However, some of the reductions were eliminated in 1982 by the Tax Equity and Fiscal Responsibility Act (TEFRA). Expenditure reductions were accomplished in the 1983 budget. However, the deficits, including off budget items, are estimated to be over $200 billion in FY 1984 and FY 1985 and over $150 billion in FY 1986 and FY 1987 according to the President's proposed budget.

Our Committee feels that the prospective deficits will result in real interest rates higher than they would have been at lower levels of deficits. These high deficits and increased rates will have adverse effects on the economy which are meaningful and worthy of attention.

To reduce the budget deficits and decrease their adverse effects, expenditure cuts should be used. All sectors of expenditures should be candidates for reduction. Since defense and direct benefit payments for individuals make up 71% of government expenditures in 1984 according to the recommended budget, these areas must be examined closely.

The Committee was skeptical of the benefits of advocating tax increases. Tax increases may have negative impacts on the long run health of the economy and seem to do little to decrease deficits. In particular, our fear is that tax increases, ostensibly to reduce deficits, may shift the political focus away from the need to reduce spending and, in the end, not achieve any real reduction in the deficit. TEFRA, was enacted to decrease budget deficits. After its enactment the estimated budget deficits for the next two years are still over $200 billion. It's actual effect on the deficit is small and it has a negative impact on the prospects for long term growth of the economy by decreasing the incentive to invest.

The Social Security compromise was a small step in the right direction, but it did not go far enough and did not solve the problem of long run viability. There was too much emphasis on increases in taxes rather than reduction in benefits. More work needs to be done on reducing the growth of benefits in the long run.

A most important need for both businesses and individuals is to have consistent tax policies over time so as to facilitate rational financial planning and reduced deficits. The tax system should be structured so as to maximize the amount of funds going to productive investment in the private sector. A healthy, growing private sector of the economy can best be facilitated by significant reductions in government spending so as to free up real resources for private investment.

Senator GORTON. Thank you very much, Mr. Kennedy.

We will now move to Mr. Herrington. You and Mr. McCormick are together, I believe.

STATEMENT OF JAMES HERRINGTON, PRESIDENT, COLDWATER NATIONAL BANK, COLDWATER, KANS., PRESIDENT, INDEPENDENT BANKERS ASSOCIATION OF AMERICA, ACCOMPANIED BY ROBERT L. McCORMICK, PRESIDENT AND CHIEF EXECUTIVE OFFICER, STILLWATER NATIONAL BANK & TRUST CO., STILLWATER, OKLA.

Mr. HERRINGTON. Thank you, Mr. Chairman.

Members of this committee, we're pleased to testify before you today. I'm Jim Herrington, president of the Independent Bankers Association of America, accompanied by Bob McCormick, chairman of our Federal Legislation Committee.

[Complete statement follows:]

STATEMENT BY

JAMES D. HERRINGTON
PRESIDENT/BOARD CHAIRMAN OF THE
COLDWATER NATIONAL BANK, COLDWATER, KANSAS

and

PRESIDENT OF THE

INDEPENDENT BANKERS ASSOCIATION OF AMERICA

BEFORE THE

SENATE COMMITTEE ON
BANKING, HOUSING AND URBAN AFFAIRS

REGARDING

OVERSIGHT HEARINGS ON THE
DOMESTIC FINANCIAL SERVICES INDUSTRY

MAY 3, 1983

Mr. Chairman, members of this distinguished Committee, we are pleased to testify before you today. The IBAA is a national trade association of slightly more than 7000 small community banks. We are heavily engaged in small business, agricultural and consumer lending in thousands of communities throughout the United States.

Your letter of invitation indicated the purpose of the hearing is to gather information on the current status of the financial services industry and to explore the future direction of that industry. It invited us to raise any issues that we find appropriate to a review of the financial services industry.

We wish that our message this morning could be that all is well with our industry. Unfortunately, this is not the case. Many of our banks are working with an unusual number of problem loans as a result of the severe recession. The agricultural economy has been severely impacted, the problems of the oil patch have been the subject of ongoing national attention, and the small business sector has suffered record bankruptcies.

The following table drawn from FDIC statistics highlights the problems facing our industry.

	Failures	Problem Banks
1980	10	218
1981	10	223
1982	42	369
1983 (to date)	15	443

Superimposed on these problems are the profound if not revolutionary adjustments now facing our industry as it approaches deregulation. It is our judgment that the pace of change now upon us is not healthy for our banks, the overall financial system and the general American economy. The recent NBC special report, Banking on the Brink, raised essentially the same question, noting that the problem-ridden international sector has not been regulated and that this deregulation model is now being applied at home.

Since the passage of the Garn/St Germain bill, the major dynamic confronting the industry is the pursuit of "hot money"--one day, market rate money--which increasingly will constitute the basis for the loan activity of our nation's financial institutions.

The numbers are staggering. Federal Reserve Board statistics indicate that since the authorization of the money market deposit account on December 14 and through April 13, $340 billion has flowed into this account--$195 [1] billion of which was held by commercial banks (as of March 30). An additional $29 billion [1] flowed into the Super Now accounts at all depository institutions with commercial banks capturing approximately 2/3 of the total. These financial flows are unprecedented in our history and are disruptive to financial institutions, particularly the thousands of financial institutions which weren't fully integrated into national and international financial markets and did not have to go to market every day to purchase their funds.

It is true that new funds are being attracted to our institutions from money market mutual funds, but most of the shifts have come from more stable, longer-term existing accounts. Savings deposits at commercial banks are down $23 billion [1] since December, small denomination time deposits are down $62 billion [1] and large denomination time deposits are down $36 billion. [1]

It has been acknowledged that these fund shifts are causing difficulties for the conduct of monetary policy. Henry Kaufman has also suggested that deregulation is placing upward pressure on interest rates. It is causing our banks serious problems in asset-liability management--problems that will

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1/ Please see Federal Reserve Statistical Release Money Stock Measures and Liquid Assets of April 22, 1983 The data covers the period ending April 13.

persist into the foreseeable future. Simply put, what good is the money if the farm economy cannot afford the price because of depressed crop prices? Longer term fixed rate loans are no longer prudent in the world of market rate money which can be easily withdrawn upon demand.

In our judgment this is the major new dynamic affecting our institutions and financial markets. It propels the drive for new sources of fee income, the pressure to override usury laws wherever they may exist, and unfortunately it is a major force whose likely effect is to consolidate the industry. It raises further questions concerning the existing system of depository insurance and the functioning and structure of our nation's regulatory system.

We break with some of our colleagues in our assessment of the costs of deregulation to date and the further deregulation that some are planning for the industry. Our assessment sees further instability, a further weakening of an institutional framework that has served the nation well, and the specter of financial concentration...before the pendulum of deregulation begins to swing back. There are some lessons we should have learned from the 1920s.

Let us now turn to some specific matters.

The Treasury's Proposal to Re-write the Bank Holding Company Act

As the Committee knows, the Treasury has been working on its proposal for some time and has been consulting the industry. The IBAA favors a more liberal application of the Bank Holding Company Act by the Federal Reserve System. We feel that the Fed has been unduly restrictive in the product mix it has allowed bank holding companies to offer. However, during these highly uncertain times we feel that it would be unwise to weaken the regulatory role of the Federal Reserve System as the Treasury proposal does. We do support prior approval for activities of bank holding companies that are closely related to and a proper incident of banking. We feel that the ongoing crisis of the loan exposure of American banks in the developing world underscores the importance of Federal Reserve regulation of the activities of bank holding companies.

We regret that Secretary Regan, in his testimony before this Committee on April 6, began to renege on the small bank exemption contained in last year's Treasury proposal. The small bank exemption would have allowed banks under $100 million which are not affiliated with a holding company to conduct new and existing securities activities through a subsidiary of a bank in lieu of forming a holding company. Since thousands of our banks are not affiliated with holding companies, Secretary Regan's posture again relegates these banks into the outer darkness in terms of new services. Yet small banks generally have been more prudent in their operations than large banks, and it is not small banks who are asking the Congress for help because of their unwise foreign loan exposures. We ask that the $100 million exemption be re-instated and that it cover new products in addition to securities.

Glass-Steagall

We continue to support the old Title V of last year's Garn Bill (S. 1720) which would have permitted banks to underwrite revenue bonds and offer money market mutual funds out of the bank. The latter provision has been rendered less important by DIDC's authorization of a money market deposit account.

We continue to favor strongly the separation of banking and commerce and feel that a bank should not be allowed to own a shoe store nor a shoe store to own a bank.

This is not an academic issue. The Garn/St Germain bill accorded thrifts the powers to make commercial loans and accept demand deposit accounts. Existing laws prevent industrial firms from owning commercial banks since obvious conflicts of lending interest could arise. Yet, laws passed before thrifts were accorded commercial lending powers remain on the books and National Steel can own an S&L. This is highly inappropriate.

And as Chairman Volcker pointed out in his testimony before this Committee on April 26, there are many other areas where "thrift powers extend well beyond those available to banks" while enjoying less regulation than that imposed on banks.

McFadden-Douglas

McFadden, Douglas and prior laws and regulations limiting the geographic gathering of deposits served and achieved the following public policy objectives:

1. A diverse banking system with strong local control and ownership characteristics;

2. A banking system less likely than other banking systems to be improperly controlled, influenced, or owned by the government;

3. A banking system less likely than other banking systems to exercise improper influence over government policy;

4. A highly competitive system with many providers of banking services competing in almost every market.

Therefore, these geographical limitatations on branching and holding company affiliation should not be changed until new laws and regulations are established which assure the continued achievement of these public policy objectives. We do not think that general anti-trust policy is adequate to achieve this result. FDIC Chairman Isaac referenced this in his testimony last Wednesday.

Deposit Insurance

The establishment of the Federal deposit insurance system constituted the single greatest contribution to fostering public confidence in the stability in our banking system in our history. Therefore, a continuing Federal role in assuring the safety of deposits placed by the American public in depository institutions is absolutely necessary.

The IBAA joins the Federal Home Loan Bank Board and the National Credit Union Administration in opposing any merger of the insurance funds.

Our policy bodies are presently meeting in Washington and will be discussing the very recent recommendations of the FDIC regarding additional changes in the insurance system. We would be happy to inform the Committee of the results of our deliberations.

Public Disclosure of Problem Loans

The philosophy that public disclosure (namely, the private sector) will be better able to regulate depository institutions than the regulators is troublesome. Loan information is highly technical and can be easily misconstrued by laymen and the media. Unfavorable disclosure of complicated business activities will not only diminish the confidentiality of bank operations, but will further reduce public confidence, which is the foundation of our banking system.

During these troublesome times, public disclosure will force our banks to tighten their lending practices to avoid having the appearance of too many "bad loans". Many of these bad loans could be worked out absent this public spotlight. In their press release of April 20 the National Association of Realtors appealed for policy changes that will allow lenders greater forebearance in loan foreclosures requesting that the regulators exercise maximum discretion in permitting delinquency solutions. Public disclosure works against this goal.

We urge this Committee and the Congress to oppose this procedure which is scheduled to begin on June 30, 1983.

Taxation of Banks

Unfortunately, all banks have been victimized in the media by the limited study of the Joint Committee on Taxation which showed that the 20 largest banks only paid taxes on domestic income in 1981 at a 2.7% rate. In fact, banks under $5 billion in assets paid a far higher rate of tax.

We ask that a memo we gave to the President when we met with him on April 12 be placed in the record at this point.

Non-bank Banks

We applauded the moratorium ordered by the Comptroller of the Currency on the acquisition or formation of non-bank banks. We recognize that this may have never happened had it not been for the interest of Chairman Volcker in this growing problem. We urge that the moratorium be extended to the Federal Home Loan Bank Board and the FDIC and that the Congress take action to plug this loophole in the Bank Holding Company Act before the moratorium expires.

We are encouraged that in his testimony before this Committee Secretary Regan stated that it is "the Administration's view that a bank or other Federally insured depository is a special form of financial intermediary which, as a matter of policy, should be treated differently from other commercial enterprises. The laws and policies that govern or relate to banking--deposit insurance, comprehensive regulation and supervision, government liquidity assistance and exemptions from securities laws--are designed to encourage savers to deposit their funds in banks, in preference to other investment media."

Unfortunately, the policies that have been advocated by this Administration--deposit-taking authority for investment houses or securities firms, for example, or resistance to imposing mandatory reserves on money market mutual funds--have undermined banking in this country. We hope that we are beginning to see a change. The long-term safety and soundness of our financial system depends on it.

Mr. Chairman, in conclusion, let me emphasize that the members of the IBAA clearly recognize that the financial marketplace is rapidly changing. We recognize that our survival as independent institutions is at stake as we make the adjustments necessary to compete in this environment of change. Unlike the larger banking institutions which are protected from the consequences of their unsound and unwise decisions by a regulatory system which is afraid to let large banks fail because of macro-economic implications, small community banks are well-aware that this assurance against failure does not apply to them. We receive no comfort from an Administration which doesn't even give lip service to the possible dangers of financial concentration--a theme which has been an integral part of our economic history. We seem to be in a time when the lessons of the 1920s when banking and commerce were not separated are being forgotten.

We are not unrealistically asking Congress to halt the changes swirling about us; we simply look to Congress for leadership to bring better order out of those developments which affect the fundamental nature of our nation's banking structure--developments which are moving too rapidly to be well-considered and which adversely affect the future safety and soundness of our banking system. It is in all of our interests to work to make these changes as gradual and orderly as possible to maintain public confidence in our financial system. To do this, the Congress must carefully review and help to channel the present pace and future agenda of banking deregulation.

Thank you. We would be happy to answer any questions you might have.

President
JAMES D. HERRINGTON, Board Chairman
Coldwater National Bank
Coldwater, Kansas 67029

First Vice President
PAUL H. BRINGGOLD, President
First National Bank
Cannon Falls, Minnesota 55009

Second Vice President
A J (JACK) KING, President
Valley Bank of Kalispell
Kalispell, Montana 59901

Treasurer
JAMES R. TAYLOR, President/CEO
McKeesport National Bank
McKeesport, Pennsylvania 15132

Independent
BANKERS ASSOCIATION OF AMERICA
WASHINGTON OFFICE
1625 MASSACHUSETTS AVENUE N.W. · SUITE 202, WASHINGTON, D.C. 20036 202/332-8980

TO: THE PRESIDENT OF THE UNITED STATES

FROM: JIM HERRINGTON, PRESIDENT
INDEPENDENT BANKERS ASSOCIATION OF AMERICA

DATE: APRIL 12, 1983

SUBJECT: THE SMALL BANK POSITION ON WITHHOLDING AT SOURCE

The member banks of the Independent Bankers Association of America are fighting for the repeal of withholding for the sake of their customers as well as their institutions. Our members are the nation's community banks--the smaller banks located in thousands of small towns and suburbs throughout the country. These banks have a special, personal relationship with their customers and communities that is quite different from the type of banking service offered by the large money-center institutions. Our bankers understand on a personal level the problems that withholding will cause their customers--the loss of the use of savings dollars during the year, the exemption procedures that can confuse elderly customers, and the embarrassing invasion of privacy as customers must file low-income exemption statements with bankers who are often personal friends as well.

Unfortunately, others who are working to prevent the repeal of withholding have attempted to link the withholding issue to other bank concerns such as taxation. A study requested by Senator Dole from the Congress' Joint Committee on Taxation reported that twenty of the nation's largest banks paid taxes on domestic income in 1981 at a 2.7% tax rate. This figure was widely reported by the press and unfairly tarnished the image of the entire banking industry. The following table sets the record straight.

EFFECTIVE TAX RATES BY SIZE CATEGORY OF BANK[1]

1981 FED Data As Compiled by
Sheshunoff and Company, Inc.

Size of Bank Deposits	Effective Tax Rate--National (Percent)		Effective Tax Rate--Selected States [2]	
			California	Kansas (Percent)
0 - 9 Million (2653 Banks)	75 percentile	31.3		
	Median	21.1	12.3	24.2
	25 percentile	9.7		
10 - 24 Million (4702 Banks)	75	31.4		
	Median	21.0	19.6	24.9
	25	8.8		
25 - 99 Million (5503 Banks)	75	28.8		
	Median	17.3	38.9	19.9
	25	3.5		
100 -499 Million (1235 Banks)	75	25.3		
	Median	11.6	27.7	5.6
	25	- 2.5		
500 -999 Million (153 Banks)	75	22.2		
	Median	9.0	*	*
	25	- 9.8		
1 Billion to 5 Bil.	75	23.1		
	Median	15.8	*	*
	25	5.6		

* Not Available

Over $5 Billion--Not listed since IBAA does not have any banks of this size in its membership. Senator Dole's study indicated that banks of this size category pay a lower effective rate of taxation than smaller banks. The study indicated that the effective tax rate of 20 largest banks on the Fortune 500 list of corporations was 2.7% in 1981.

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[1] These effective tax rates do not include the mandatory sterile reserve requirements which are held on transaction accounts.

[2] 25 and 75 percentile breakouts are not available from study.

This chart underscores only one of the reasons why the nation's largest banks have been less supportive of the industry-wide effort to repeal withholding. Not only are the largest banks the most vulnerable to suggestions that they enjoy excessive tax preferences, but the implementation of withholding will impose operational burdens which disproportionately handicap smaller institutions at a time when banking deregulation is already creating tremendous strains.

For example, over $350 billion has flowed into the newly-authorized money market deposit accounts since December 14, 1982 and Federal Reserve statistics indicate that 61.5% of these funds are merely internal transfers from existing low-cost savings and time deposits. Small banks have had a disproportionate share of these internal transfers.

The large institutions have been quick to note that these pressures on earnings combined with the massive start-up costs of withholding (independent surveys indicate that the temporary float provisions will recover less than 10% of actual costs) are likely to weaken their smaller competitors. The April 4 issue of Banking Expansion Reporter observed: "The withholding of dividends and interest appears to favor larger institutions... The resulting incremental advantage to larger institutions should increase just a tad their expansion possibilities and opportunities. The most obvious possibility or opportunity is the owner of the small bank that decides enough is enough and starts looking for a buyer."

The Administration should be clearly aware that the withholding provision it supports is unfairly weighted against the smaller banks that serve Main Street America.

Senator GORTON. Mr. Herrington, was it the message to the President on withholding that you wished to be included as a part of this?

Mr. HERRINTON. Yes.

Senator GORTON. It's attached to your statement and it will be included with your statement in the record.

Mr. HERRINTON. Thank you.

Senator GORTON. Mr. Baldwin, we will proceed to you.

STATEMENT OF H. FURLONG BALDWIN, PRESIDENT, MERCANTILE BANKSHARES CORP., BALTIMORE, MD.; CHAIRMAN, ASSOCIATION OF BANK HOLDING COMPANIES

Mr. BALDWIN. Mr. Chairman, I represent the Association of Bank Holding Companies. Along with the text of my statement I have furnished the committee with copies of a document put together at our request by Golembe Associates. The paper is entitled "Major Events in the Financial Industry, January 1, 1981–March 31, 1983." I should like to request that it either be made part of today's hearing record or placed in the committee files as you may decide. This 23 pages provides a graphic picture of the rapidly evolving events that have impacted on financial institutions and are a fitting background to the statement we are submitting today.

Senator GORTON. Without objection, the statement will be included in the record.

[Complete statement follows:]

ASSOCIATION OF BANK HOLDING COMPANIES
730 Fifteenth Street, N.W.
Washington, D.C. 20005

Statement to
Committee on Banking, Housing and Urban Affairs
United States Senate
May 3, 1983

Mr. Chairman and members of the Committee, I am H. Furlong Baldwin, President of Mercantile Bankshares Corporation, Baltimore, and Chairman of the Association of Bank Holding Companies, on whose behalf I am appearing today. Accompanying me is the Association's President, Donald L. Rogers.

We applaud your intention to resume this Committee's consideration of competitive and structural questions affecting the financial services industry. The "Garn-St Germain Depository Institutions Act of 1983" (P.L. 97-320) represents a major step along the road toward providing regulated depository institutions with the wherewithal to meet the new competition from other, essentially unregulated, financial services companies. More needs to be done, however, and our Association will work with you to continue the process you have initiated.

Your "Committee Print" dated July 27, 1982, was a landmark document, Mr. Chairman, because, among other things, it contained in Title V much-needed improvements in the laws affecting the securities activities of banks and bank holding companies. We fully supported your efforts at that time to retain Title V in the final version of your bill, and we regret that it was not possible to do so.

Our Association strongly favors the Administration's proposed "Bank Holding Company Deregulation Act." We have not yet had an opportunity to examine the language of the 1983 version of the proposal, and we may discover a minor problem or two among its many provisions when we do. Nevertheless, we strongly support its basic thrust and structure; the Administration's bill is far too important for it to be stalled indefinitely pending the development of a more perfect version. This is one of the rare moments in history when an entire Administration is committed to moving forward with meaningful improvements in banking laws, and the opportunity for enactment of constructive legislation should not be missed. We view this as our top priority.

The Administration's bill, as you know, deals with products and services that may be offered by bank holding companies. Another key banking issue in the 1980's is the deregulation of geographic restrictions on commercial banking. Commercial banks, and bank holding companies, now stand alone as the only financial institutions still locked into a structure established by Congress and the States fifty or more years ago. We now have nationwide thrift institutions, brokerage houses, insurance companies, retailers, finance companies, and others offering banking services to individuals and businesses. What we do not have is a rational commercial banking structure to enable our industry to meet this greatly increased competition.

Moreover, because competition is so keen, "loopholes" abound. The latest is the evolution of so-called "non-bank banks." This sounds sinister, but "non-bank banks" are simply entrepreneurial responses to the marketplace and present law. Before Congress rushes to close this "loophole," it should consider well the fact that the definition of "bank" in the Bank Holding Company Act has become perhaps the fundamental element in that law. As such, it represents, as all such definitions do, a compromise, made in 1970. Not all financial entities were defined as "banks" in 1970, and there is no question that if the definition is reopened, not all financial entities will be defined as "banks" in 1983.

For example, Section 333 of the Garn-St Germain Act exempts all FSLIC-insured institutions from the definition of "bank" in the Act, a sweeping exemption by any definition. Now if Congress were to declare that "bank" means only those institutions either insured or eligible for insurance by the Federal Deposit Insurance Corporation, then it would be sanctioning by law a basic competitive inequality. Our financial competitors could continue to enter the banking business through the acquisition of a thrift, and utilize all of the new powers granted thrifts by the Garn-St Germain Act, while bank holding companies would continue under the confines of the Bank Holding Company Act, which contains far more restrictions and impediments than are applicable to savings and loans, savings banks, and savings and loan holding companies. We would, of course, oppose such legislation.

Rather than considering additional restrictions in a vain attempt to close "loopholes," Congress should consider legislation to deregulate and rationalize the financial services industry. We think a much more effective response to marketplace forces is to allow bank holding companies to acquire one another across state lines. Our Association's proposal, which is attached to my statement, amends the Douglas Amendment (Section 3(d) of the Bank Holding Company Act) to permit a bank holding company to acquire another such company in each contiguous state during the first five years after enactment of the new law. Companies with less than $500 million in assets would be exempt from the numerical limitation. Each acquisition, as now, would be subject to approval by the appropriate regulatory authorities. This proposal allows for geographic deregulation on a gradual basis, and guards against any undue concentration of banking assets. It also has the great virtue of leaving untouched the traditional dual banking system. We recognize that there are other alternatives, including immediate nationwide bank holding company expansion, and ours is not the only solution. We thoroughly agree with Chairman Garn's statement in announcing these oversight hearings that "whether we like it or not, interstate banking is upon us." Again, we will cooperate in efforts by you and the Committee to develop a legislative solution in this area.

The question of regulation and supervision is also of concern to members of our Association. In response to the request for comments published by Vice President Bush's Task Group on Regulation of Financial Services, our Association has filed a statement recommending that a new Federal Financial Institutions Board be established to assume the regulatory and supervisory functions now exercised by the Federal Reserve Board, the Comptroller of the Currency, the Federal Home Loan Bank Board, and the National Credit Union Administration. Members of the new Board would be appointed by the President and confirmed by the Senate. The Board would include the Chairman of the Federal Reserve Board and the Federal Deposit Insurance Corporation as ex officio members.

The FDIC would continue as a separate agency, and its insurance fund would be augmented by the insurance funds of the Federal Savings and Loan Insurance Corporation and the National Credit Union Administration. For a fixed period of time, the insurance funds of the three agencies would be kept segregated within FDIC.

Under our proposal, the Federal Reserve Board would be freed of the burden of banking regulation and supervision in order to focus its primary attention on the conduct of monetary policy. Because the Fed's Chairman would serve on the Board of the new agency, there would be no question that the Fed would continue to be aware of developments affecting all financial institutions.

A key aspect of our Association's proposal is that the newly-established Federal Financial Institutions Board be directed by Congress to preserve and enhance competition among financial services companies in all relevant product and geographic markets. The constituent institutions under the Board's regulation and supervision would be encouraged to meet their obligations as federally-chartered and/or federally-insured organizations to provide competitive financial services to all of their customers.

We believe such a regulatory change is needed for two reasons. First, Public Law 97-320, as we have noted above, has essentially homogenized the powers of depository institutions. Recognizing this as a fait accompli, we believe there is no longer a justification for separate agencies to regulate and supervise what are, in essence, similar institutions. Second, all depository institutions require a strong voice in government to remain viable competitors with other companies offering financial services. Strong, unified leadership is necessary so that depository institutions will be in a position in the mid-1980's and beyond to offer the products and services the public needs and will be demanding.

As you may have noted, our Association's proposal is along the lines of S. 559, Senator Proxmire's "Federal Bank Commission Act of 1983," except that we recommend including FHLBB and NCUA in the new agency as well as the bank regulators, and leaving FDIC separate.

In conclusion, Mr. Chairman, the Association appreciates the efforts you and other members of the Committee made in the last Congress to obtain reform of laws affecting banks and bank holding companies, and we look forward to working with you in this Congress in furtherance of that goal.

A BILL

To Amend the Bank Holding Company Act of 1956 to Promote Regional Banking Deregulation

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

Section 1. This Act may be cited as the "Regional Banking Deregulation Act."

Section 2. Subsection 3(d) of the Bank Holding Company Act of 1956 (12 U.S.C. 1842(d)) is amended by striking the period at the end of the first sentence and inserting in lieu thereof the following proviso: "; *Provided, however*, that after one year from the date of enactment of this proviso, an application may be approved under this section which will permit any bank holding company to acquire any voting shares of, interest in, or all or substantially all of the assets of, or merge or consolidate with, a bank holding company the banking subsidiaries of which are located in states that are contiguous or adjacent to the state in which the operations of the acquiring bank holding company's banking subsidiaries were principally conducted on July 1, 1966, or on the date such company became a bank holding company, whichever is later; but for a period of five years from the date of enactment of this proviso, the Board shall not approve any application under the provisions of this proviso that would permit a bank holding company which has assets in excess of $500,000,000 to acquire more than one bank holding company in each contiguous or adjacent state."

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Major Events in the Financial Industry
January 1, 1981 - March 31, 1983

THE BANKING INDUSTRY

-- Geographic Expansion

Unilateral noncontrolling investments with future commitments in out-of-state institutions

- In July 1981, Chase Manhattan Corporation purchased nonvoting preferred stock of both Equimark Corporation and Equibank, and made a $75 million loan to Equibank in return for a 15-year option for 100 percent of Equibank's stock, exercisable when prohibitions against interstate banking are eliminated.

- In July 1981, Marine Midland Banks, Inc. agreed to buy newly issued common stock of Industrial Valley Bank & Trust Company, representing 4.9 percent of outstanding common shares and agreed to purchase $22.3 million of nonvoting preferred stock in exchange for warrants to purchase an additional 20 percent of common stock when banking laws permit.

- In October 1981, First National Boston Corporation agreed to purchase $4.5 million in convertible preferred stock from Casco Northern Corporation, accompanied by 15-year warrants to purchase additional common shares, for an ultimate 20 percent ownership position when legally permissible.

- In December 1981, First Bank System entered into a 15-year agreement with Banks of Iowa whereby First Bank System would acquire Banks of Iowa, when permissible, and First Bank System would make an immediate purchase of 21 percent of outstanding voting common stock from an individual shareholder.

- In February 1982, Chemical New York Corporation revised an agreement with Florida National Banks of Florida, Inc. in which Chemical would purchase Florida National Stock and the two institutions would plan to merge when permitted by law.
- In March 1982, Marine Midland Banks, Inc. agreed to purchase $70 million in nonvoting preferred stock of Centran Corporation, while receiving 20-year warrants to purchase newly issued common stock representing 37.5 percent of total outstanding common, when banking laws permit.
- In March 1982, Girard Company agreed to purchase 4.8 percent of the outstanding common stock of Guarantee Bancorp, Inc. for $1.2 million and to purchase a ten-year note which is convertible into common stock when interstate banking regulations permit, to bring Girard's total to 8.5 percent.
- In December 1982, First National Boston Corporation agreed, in principal, to pay $25 million for 4.9 percent of Colonial Bancorp, Inc.'s stock and received an option to buy an additional 20 percent of Colonial's common stock once interstate banking is permitted.
- In February 1983, Mercantile Texas Corporation agreed to purchase nonvoting, preferred stock of Utica Bank-Shares Corporation, with detachable warrants to enable Mercantile to purchase 24.9 percent of Utica's unissued common stock if interstate banking is permitted.

Noncontrolling cross investment programs

- In January 1982, AmSouth Bancorp of Alabama, Trust Company of Georgia and South Carolina National Corporation agreed that each will buy $2 million of nonvoting, nonconvertible, redeemable preferred stock of the other two institutions, but there is no formal agreement for future action nor were any warrants or options exchanged in the transaction.

Informal affiliations

- In April 1982, the "Western Alliance" was formed when six bank holding companies -- Valley National Corp., Wells Fargo & Company, Bancorp Hawaii, Inc., Seafirst Corp., United Banks of Colorado, Inc., and U.S. Bancorp -- announced that they had agreed to investigate offering reciprocal check-cashing privileges to their member customers.

Franchise operations

- In March 1982, First Interstate Bancorp announced plans to begin franchise operations in which First Interstate would offer a bundle of services to other institutions in other states which would adopt the First Interstate Bank name.

State laws which permit interstate banking

- In January 1981, the New York legislature passed a law which permits out-of-state bank holding companies to acquire in-state institutions if their state has reciprocal legislation.
- On February 18, 1981, Delaware Governor Pierre S. duPont IV signed an interstate banking law which permits out-of-state bank holding companies to establish operations in Delaware if they operate in a manner and at a location that does not attract customers from the general public to the detriment of in-state institutions, eliminates interest rate and loan fee ceilings on consumer lending, and establishes a regressive tax structure.
- On June 2, 1982, the Governor of Alaska signed into law legislation which permits out-of-state bank holding companies to acquire in-state banks.
- On December 30, 1982, the Governor of Massachusetts signed into law an act permitting depository institutions or their holding companies in any of the five other New England states to merge with or acquire banks or thrift institutions in Massachusetts, so long as the entering institution is headquartered in a New England state that has enacted a reciprocal law.

- On March 4, 1983, the Governor of South Dakota signed into law legislation which permits out-of-state bank holding companies to acquire or charter a state bank which, in turn, may own an insurance company.

Controlling interstate acquisitions

- In October 1981, Girard Company, Pennsylvania, acquired Farmers State Bank, located in Delaware, pursuant to a special amendment to Delaware's banking laws.
- In June 1981, NCNB Corporation, reached an agreement to acquire First National Bank of Lake City, Florida.
- In June 1981, Citibank formally opened its national credit card operation in South Dakota.
- In July 1981, First Maryland Bancorp announced plans to establish a new bank in Delaware to take advantage of Delaware's less restrictive banking laws.
- In July 1981, the executive committee of Flagship Banks, Inc. approved, in principal, a merger offer from Royal Trust Company, Ltd., Toronto.
- On August 6, 1981, Citicorp announced that it had applied to establish a state-chartered bank in Delaware to provide cash management services to corporations and institutions carrying demand deposits with Citibank.
- In September 1981, Fidelity National Corporation, parent of Fidelity National Bank, announced it had applied to the Delaware Banking Commissioner, the Comptroller of the Currency, and the Federal Reserve Board for permission to set up a bank in Delaware.
- In November 1981, Northern Trust Corp of Chicago filed applications with the Comptroller of the Currency and the Federal Reserve Board to permit a Florida trust subsidiary -- Security Trustco of Sarasota -- to become a full-service commercial bank.
- In December 1981, J. P. Morgan & Co. became the first out-of-state bank holding company to open a bank

subsidiary in Delaware since passage earlier in 1981 of Delaware's new banking law.

- On March 21, 1983, the Federal Reserve Board approved the application of Norstar Bancorp, Inc., Albany, New York to acquire Northeast Bankshare Association, Portland, Maine.
- On March 29, 1983, the Federal Reserve Board approved the application of Rainier Bancorporation, Inc., Seattle, Washington, to acquire People's Bank & Trust Company, Anchorage, Alaska.

ATM Networks

- In February 1981, the birth of "Cirrus" was announced when 12 multibillion dollar banks announced they were forming an ATM network.
- In April 1981, American Express Co. announced that its cardholders will be able to get cash 24 hours a day at The Exchange (a national shared automated teller machine) machines selected by participating financial institutions.
- In September 1981, Visa announced plans to establish a global network of shared ATM's owned by member banks.
- In October 1981 Master Card International chose a new logo and the name "Master Teller" for its planned cash dispersement service through an international network of its member bank's automated teller machines.
- On April 7, 1982, the first solid alliance of major regional and money center banks for shared ATM usage was announced with formation of Plus Systems, Inc.
- In October 1982 the nation's first coast-to-coast electronic banking transaction was made via The Exchange, a cooperative ATM network.
- In January 1983, the Regional Interchange Association, an ATM network consisting of a dozen regional ATM networks, announced it will become nationwide and change its name to National.

- In February 1983, Safeway Stores, Inc. announced that it will soon begin placing automated teller machines in 50 Los Angeles-area supermarkets as a first step in a nationwide program.

-- Product Expansion

Bank expansion into brokerage operations

- In November 1981, BankAmerica Corp. became the first bank holding company to announce an intention to purchase a discount brokerage firm.
- In February 1982, Security Pacific National Bank was the first bank to offer discount brokerage services to its customers in affiliation with an outside brokerage firm, in this case, Fidelity Brokerage Services, Inc. Hundreds of other banks have followed Security Pacific's approach and began offering brokerage services in conjunction with outside brokerage firms.
- In August 1982, Security Pacific National Bank received the first approval by the Comptroller of the Currency to establish a de novo brokerage subsidiary of a bank.
- In September 1982, the Comptroller of the Currency issued its first approval for a bank to acquire a brokerage firm when Union Planters was permitted to acquire Brenner Steed & Associates, a Memphis-based discount brokerage firm.
- In December 1982, First Union Corp of North Carolina received OCC approval to acquire Salem Securities, Inc., a discount broker.
- In January 1983, the Federal Reserve Board approved the application of BankAmerica Corporation to acquire Charles Schwab & Co.
- In January 1983, Security Pacific received approval by the Comptroller to acquire Kahn & Co., a discount broker.
- In February 1983, the Chase Manhattan Corporation applied to the Federal Reserve Board to acquire Rose & Co., a discount broker.

- United Jersey Banks has applied to the Federal Reserve Board to acquire Richard Blackman & Co., a discount broker.

- In March 1983, Security Pacific announced plans to purchase two New York City bond brokers.

Breaking down the prohibitions of the Glass-Steagall Act

- On February 24, 1981, the Supreme Court upheld a nine year old Federal Reserve Board regulation that allows bank holding companies to act as investment advisors to closed-end investment companies and to organize, control and manage them as subsidiaries.

- In September 1982 the Federal Deposit Insurance Corporation issued a policy statement on the applicability of the Glass-Steagall Act to securities activities of subsidiaries of insured nonmember banks which concluded that the Act does not control the activities of these subsidiaries.

- On October 21, 1982, the Comptroller of the Currency approved the establishment by Citibank, N.A., of common trust funds for collective investments of individual retirement accounts.

- On November 2, 1982, the United States Court of Appeals for the District of Columbia in its decision on A. G. Becker, Inc. v. Board of Governors, held that commercial paper is not a security under the Glass-Steagall Act.

- Citicorp received permission from the Federal Reserve Board to form a nonbank subsidiary to engage in the activities of underwriting and dealing in certain government securities and money market instruments which the Board said were not "securities" subject to the prohibitions of the Glass-Steagall Act.

- On December 14, 1982, the Federal Reserve Board sent a letter to the Comptroller of the Currency on the matter of the proposed Dreyfus National Bank & Trust Company which said that the acquisition of the trust company by Dreyfus "would result in an affiliation and apparently management interlocks between a member bank and the Dreyfus Mutual Fund in violation of sections 20 and 32" of the Glass-Steagall Act.

Insurance activities

- In 1981 the Supreme Court let stand a lower court decision by the U.S. Court of Appeals for the District of Columbia that three bank holding companies could sell credit-related property and casualty insurance.
- On April 29, 1982, the Federal Reserve Board denied the application of Seafirst Corporation to reinsure group mortgage life insurance.
- In January 1983, BankAmerica Corporation announced it had acquired a 24.9 percent interest in H. L. Capital Management Corporation, a holding company engaged in the insurance business, through its small business investment company subsidiary.

Futures commission merchant activities

- In April 1982, North Carolina National Bank received approval from the Comptroller of the Currency to establish a *de novo* operating subsidiary that will function as a futures commission merchant.
- On July 1, 1982, the Federal Reserve Board, approved the application of J. P. Morgan & Company, to engage in certain futures commission merchant activities.

Establishment of a nonbank bank by a bank

- As of September 30, 1982, 81 bank holding companies had trust company subsidiaries located outside their home state.
- On February 4, 1983, the OCC approved the establishment of a national bank in Ohio to handle only credit card accounts. The parent of the new national bank is Citizens Fidelity Corp., Louisville, Kentucky.

- As of March 1983, Comerica had an application for a proposed national bank in Ohio, pending at the Federal Reserve.

Other nonbanking activities

- On November 18, 1981, the Federal Reserve Board amended Regulation Y to include the issuance of travelers checks among the nonbank activities permissible for bank holding companies.
- The Federal Reserve Board revised Regulation K to permit member banks, bank holding companies and Edge Act corporations to acquire a minority interest in foreign companies which operate domestic businesses here if the banking organization meets three criteria set by the Fed.
- On March 12, 1982, the Federal Reserve Board approved the application of First Bancorporation, Salt Lake City, Utah, to acquire Beehive Thrift & Loan Company, an industrial loan company in Salt Lake City, and held that NOW accounts were demand deposits within the meaning of section 2(c) of the Bank Holding Company Act.
- Effective April 20, 1982, Regulation Y was amended to allow bank holding companies to provide management consulting services to nonbank depository institutions.
- On July 9, 1982, the Federal Reserve Board approved the application of Citicorp to engage in a wide range of data processing and transmission activities through a subsidiary, Citishare Corporation.
- On September 1, 1982, the Federal Reserve Board granted approval to BankAmerica Corporation to arrange equity financing for commercial or industrial income-producing real estate.
- On November 15, 1982, the DIDC authorized a new account pursuant to the Garn-St Germain Act, which requires a minimum deposit of $2,500. There is no interest rate ceiling and only three drafts can be written per month.

- On December 6, 1982, the DIDC authorized the Super NOW account -- a transactional account subject to a $2,500 minimum balance but no interest rate ceiling. An unlimited number of third party drafts or checks can be written on the Super NOW.

- On December 6, 1982, the Federal Reserve approved the acquisition by First Security Corp. of Salt Lake City, Utah to acquire Murray First Thrift & Loan Company and Capital Thrift & Loan Company, both industrial loan companies in Salt Lake City, and held that neither industrial loan company could offer demand deposits, NOW's, transaction accounts, or "sweep accounts with transactional capabilities" and still remain a nonbank subsidiary while also offering commercial loans.

- On February 16, 1983, the Federal Reserve Board approved the application to establish a de novo office in New York of International Treasury Management Limited, Hongkong, a newly formed subsidiary of the Hongkong and Shanghai Banking Corporation and its U.S. subsidiary, Marine Midland Banks, Inc., of Buffalo, New York, and expanded the powers of bank holding companies to include: (1) providing advice concerning foreign exchange operations, policy and procedures; and (2) arranging the execution of foreign exchange transactions.

B. THE SECURITIES INDUSTRY

Money market funds

- In November 1982, money market funds were at their peak and had assets of about $230 billion, representing 17 percent of total commercial bank deposits.

Sweep of bank deposits into money market funds

- Starting in 1981, the nation's money market funds offered programs through banks whereby bank deposits over a certain level would automatically be swept into money market funds. Until the advent in late 1982 of bank money market deposits, most major money market funds had such sweep arrangements with one or more banking institutions.

Asset management accounts

- In 1978, Merrill Lynch launched its Cash Management Account, making available to consumers an integrated array of financial services from a single source. A substantial number of major retail brokerages now offer CMA's.
- In early 1983, Fidelity Group launched an Asset Management Account which added numerous other services to the array offered to customers, including direct payroll deposit and telephone bill-paying services.

Sale of insured accounts

- In September 1981, Merrill Lynch began making available to its customers All Savers Certificates offered by California Federal Savings & Loan Association of Los Angeles, California.
- In September 1981, Fidelity Group joined forces with the Provident Institution for Savings in Boston to offer All Saver Certificates to Fidelity's customers.
- In June 1982, Merrill Lynch originated the sale of negotiable depository institution certificates of deposit through its brokerage offices, offering small denomination, federally insured CD's.
- In January 1983 Dean Witter, a subsidiary of Sears, Roebuck & Co., began offering its version of the insured money market account.
- In February 1983 Prudential-Bache began marketing insured money market accounts of Citibank (New York State), N.A.
- In March 1983, The Calvert Group of money market funds began selling the money market accounts of six banks and thrifts.
- In March 1983, The VanGuard Group began offering a privately insured account.

Electronic funds transfer

- In September 1981, the Fidelity Management Group announced that it had developed an electronic funds transfer system that may eventually allow customers of any financial institution to automatically transfer funds from NOW or checking accounts into a Fidelity Group money fund.
- In December 1982, Paine Webber announced that it will soon be able to offer customers access to Master Teller Interchange (a nationwide ATM network) through an arrangement with State Street Bank & Trust Co. of Boston.
- In December 1982, Fidelity Group announced it will begin offering an ATM network to its customers through an arrangement with Shawmut Bank of Boston.
- In February 1983, State Street Bank & Trust Co., Boston Massachusetts, announced it will open a New England Regional ATM network to investors in Edward D. Jones & Co.'s, Daily Passport & Trust.

Securities firms with operating nonbank bank affiliates

- On August 31, 1981, the FDIC stated it would not disapprove the indirect acquisition of Boston Safe Deposit & Trust Company, Massachusetts, by American Express.
- The Boston Company is affiliated with Trust Company of Boston, Massachusetts.
- Capital Research & Trust Company is affiliated with Capital Guaranty & Trust Company, California.
- Eaton & Howard-Vance, Sanders, is affiliated with Investors Bank & Trust Company, Massachusetts.
- The Ohio Company is affiliated with the Ohio Trust Company, Ohio.
- Frank Russell Company is affiliated with Russell Trust Company, Washington.

- The VanGuard Group, Inc. is affiliated with VanGuard Fiduciary Trust Company, Pennsylvania.

- Washington National Insurance Company is affiliated with Washington National Trust Company, Illinois.

- Wellington Management Company is affiliated with Wellington Trust Company of Boston, N.A.

- In 1982, E. F. Hutton became affiliated with Hutton Trust Company, Delaware.

- On December 27, 1982, Dreyfus Corporation announced it had completed its acquisition of Lincoln State Bank of East Orange, New Jersey.

- On December 31, 1982, Marsh McLennan received permission to charter a Massachusetts-chartered trust company.

- In January 1983 Trust Management Bank, Massachusetts, an affiliate of Rollert & Sullivan, Inc., received a trust company charter in Massachusetts.

- On February 2, 1983, J & W Seligman Trust Company, N.A., New York, an affiliate of J & W Seligman & Company, received a national bank charter.

- On February 7, 1983, the Comptroller of the Currency granted a charter to Dreyfus Corporation to open the proposed Dreyfus National Bank & Trust Company in New York.

- On February 10, 1983, Fidelity Group gained approval to open a bank, Fidelity Bank & Trust Company, in New Hampshire.

- On February 18, 1983, the New Jersey State Banking Commission approved a limited state bank charter for Drexel Trust Co., a subsidiary of Drexel Burnham Lambert, Inc.

Other activities of securities firms

- In 1981, E. F. Hutton Group, Inc. acquired International Paper Credit Corporation, a commercial finance subsidiary. It will provide a base from which Hutton can expand to compete directly with commercial banks in asset-based financing.

- On June 29, 1981, the shareholders of Shearson Loeb & Rhoades and American Express Company approved the acquisition of Shearson by American Express.
- In early 1982, Merrill Lynch created a new subsidiary, Capital Resources, from which it plans to engage in lending to commercial borrowers.

C. THE THRIFT INDUSTRY

Interstate savings and loan mergers

- On September 8, 1981, Citizens Savings & Loan Association, San Francisco, California, acquired West Side Federal, New York, New York, and Washington Savings & Loan, Miami Beach, Florida.
- On November 20, 1981, Glendale Federal Savings & Loan Association, Glendale, California, acquired First Federal of Broward County, Fort Lauderdale, Florida.
- On December 10, 1981, City Federal Savings & Loan Association, Elizabeth, New Jersey, acquired Boca Raton Federal, Boca Raton, Florida, and Mohawk Savings & Loan, Newark, New Jersey.
- On December 18, 1981, Home Savings of America, Los Angeles, California, acquired Security Federal, Sikeston, Missouri; Hamiltonian Federal, Ladue, Missouri; and Southern Federal of Broward County, Pompano Beach, Florida.
- On January 15, 1982, Home Savings of America, Los Angeles, California, acquired Republic of Texas Savings Association, Houston, Texas; Buffalo Savings & Loan, Houston, Texas; Royal Federal Savings Association, Dallas, Texas; El Centro Federal, Dallas, Texas; Civic Savings & Loan Association, Irving, Texas; and Hyde Park Savings & Loan, Chicago, Illinois.
- On February 5, 1982, California Federal Savings & Loan Association, Los Angeles, California, acquired United

Federal of Broward County, Fort Lauderdale, Florida; Guaranty Federal, Adel, Georgia; Peach State Federal Loan, Bremen, Georgia; and First Federal, Sylvania, Georgia.

- On March 15, 1982, Northeast Savings, Hartford, Connecticut, acquired Schenectady Savings Bank, Schenectady, New York.
- On May 28, 1982, Golden West Financial Corporation, parent of World Savings & Loan Association, Oakland, California, acquired First Shares, Inc., parent of Majestic Savings & Loan, Denver, Colorado, and Commerce Savings & Loan, Shawnee, Kansas.
- On June 30, 1982, Perpetual American Federal Savings & Loan Association, Washington, D.C. acquired Washington-Lee Federal, McLean, Virginia.
- On August 2, 1982, Erie Savings Bank, Buffalo, New York acquired American Federal, Southfield Michigan; Harris County Federal, Baytown, Texas; and First Federal of Mid-Florida, DeLand, Florida.
- On August 2, 1982, Perpetual American Savings & Loan Association, McLean, Virginia, acquired Guardian Federal, Silver Spring, Maryland.
- On August 2, 1982, First Federal Savings & Loan Association, Phoenix, Arizona, acquired Mutual Savings & Loan, El Paso, Texas.
- In September 1982, Capital Savings, Olympia, Washington, acquired Havre Federal Savings, Havre, Montana.
- In September 1982, Carteret Savings & Loan, Newark, New Jersey, acquired First Federal Savings & Loan, Delray Beach, Florida.
- In October 1982, Northeast Savings, Hartford, Connecticut, acquired First Federal Savings & Loan, Boston, Massachusetts, and Freedom Federal Savings & Loan, Worcester, Massachusetts.
- In October 1982, Sooner Federal Savings & Loan, Tulsa, Oklahoma, acquired Corsicana Federal Savings & Loan,

Corsicana, Texas, and Modern Savings & Loan, Pasadena, Texas.

- In November 1982, Empire of America, DeLand, Florida, acquired Island Federal Savings & Loan, Hempstead, New York and South Shore Federal Savings & Loan, Masapequa, New York.
- In December 1982, Anchor Savings Bank, Northport, New York, acquired Peachtree Federal Savings & Loan, Atlanta, Georgia, and First Federal Savings & Loan, Cordele, Georgia.
- In December 1982, Glendale Federal Savings & Loan, Glendale, California, acquired Tampa Federal Savings & Loan, Tampa, Florida.
- In March 1983, Peninsula Savings & Loan, FA and First Federal Savings & Loan Association, both of Newport News, Virginia, were acquired by 1001 Holding Inc., a wholly owned subsidiary of First Federal of Michigan.

Acquisition of thrifts by nonthrifts

- In June 1981, Security Capital Corp, New York, New York, a diversified company in the real estate and building field, agreed to acquire Benjamin Franklin Savings Association, a Houston-based savings and loan subsidiary of the Mischer Corp., also a real estate firm.
- On February 21, 1982, the FDIC approved the assisted merger of Farmers & Mechanics Savings Bank, Minneapolis, Minnesota, into Marquette National Bank, Minneapolis.
- On March 15, 1982, the FDIC approved the granting of financial assistance in the merger of Fidelity Mutual Savings Bank, Spokane, Washington, into First Interstate Bank of Washington, N.A., Seattle, Washington.
- On April 4, 1982, the Federal Reserve Board approved the application of Interstate Financial Corporation, Dayton, Ohio, to acquire Scioto Savings Association, a state-chartered, state-insured savings bank, placing a

number of restrictions on the transaction. Scioto was a troubled institution.

- On September 28, 1982, the Federal Reserve Board approved Citicorp's acquisition of Fidelity Federal Savings & Loan Association of San Francisco, while attaching several stringent conditions to the transaction.
- In October 1982, Landmark Land Company, a real estate company based in Carmel, California, acquired Heritage Federal Savings & Loan, Bossier City, Louisiana and Dixie Federal Savings & Loan, New Orleans, Louisiana.
- In October 1982, the Westport Co., a real estate firm headquartered in Westport, Connecticut, agreed to acquire Dade Savings & Loan Association of Miami.
- In November 1982, Associates First Capital Corporation, the finance subsidiary of Gulf & Western, announced plans to acquire Heritage Federal Savings & Loan Association, Oakland, California.
- In December 1982, City Investing Co., which has interests in manufacturing, housing, consumer services and insurance, announced it will sell Southern California Savings & Loan Association, Beverly Hills, California to Securities Group, a New York brokerage firm, subject to FHLBB approval.
- In October 1982, Parker Pen Corporation announced the acquisition of 99 percent of the stock of Brady Savings & Loan Association in California.
- In December 1982, the FSLIC, for the first time, arranged a formal bidding process for a "phoenix" -- Suffolk County Federal Savings & Loan Association, Centereach, New York.
- In January 1983, the Dreyfus Corporation submitted an application to the Federal Home Loan Bank Board to acquire Metropolitan Savings & Loan Association, Arlington, Virginia.
- In March 1983, Thomson McKinnon has made an offer to buy First Federal Savings & Loan Association of Madison, Connecticut.

Product expansion by thrifts

- On July 14, 1981, the Federal Home Loan Bank Board ruled that federal savings and loans and mutual savings banks may offer a new mortgage instrument that combines graduated payments and adjustable interest rates.

- On September 4, 1981, the Federal Reserve Board said that approximately 1,000 thrift institutions had either filed or were in the process of filing agreements that would enable them to apply for discount window loans.

- On May 6, 1982, the application of Coast Federal Savings & Loan Association of Sarasota, Florida, and Perpetual American Federal Savings & Loan Association, Washington, D.C. to establish a brokerage firm, was approved by the Federal Home Loan Bank Board.

- In October 1982, First Nationwide Savings of San Francisco announced that it was launching a nationwide franchise program to other thrift institutions in which it will market a wide range of services and use a uniform name.

- In November 1982, Coast Federal Savings & Loan Association, Sarasota, Florida, opened the first Invest Center in its offices. Invest Centers offer broker/dealer services in which investment advice is given to customers.

- In November 1982, Western Savings & Loan Association, Phoenix, Arizona, the major subsidiary of Western Financial Corp., acquired 24.9 percent of the Phoenix-based company, Del E. Webb Corp., which has interests in the leisure and gambling business as well as construction and real estate.

- City Federal Savings & Loan Association, New Jersey, acquired a nationally chartered trust company, City Trust Services, N.A.

- In December 1982, the North Carolina Savings & Loan League has established a subsidiary to channel discount brokerage services to its 161 member thrifts.

- In December 1982, Beverly Hills Savings & Loan Association agreed to acquire three private companies which have consulting actuaries and pension and profit-sharing plan administrators.
- Buffalo Savings Bank announced the planned acquisition of United National Corp., a New York-based real estate investment and management concern whose holdings include luxury properties in New York, Florida and California.
- In March 1983 the first major syndicated lending program by thrift institutions was announced by Western Savings & Loan Association of Phoenix. The group is called Savers Capital.
- In March 1983 the second major syndicated lending program was also announced by Great American Federal Savings & Loan, San Diego, California. The group is to be called Financial American Network.

D. THE INSURANCE INDUSTRY

- In February 1981, Prudential Insurance Company of America signed an agreement to acquire the Bache Group, Inc.
- In July 1981, Prudential Insurance Company, made a tender offer for Connecticut General Mortgage and Realty Investment Trust.
- In September 1981 the Prudential Insurance Company announced that it was developing an attractive back-loaded, fixed-income annuity product that its general agents will be selling to compete with the individual retirement accounts offered by banks and thrifts.
- In September 1981, the U.S. Ninth Circuit Court of Appeals ruled that major commercial banks and insurance companies cannot have the same directors without violating the antitrust laws.
- In December 1981, the Pennsylvania Department of Banking approved the formation by Prudential Insurance Company of a trust company in Dresher, Pennsylvania.

- In 1982, Prudential and Travelers began to engage in shorter-term lending to corporations, offering revolving credit lines and term loans from two to ten years. Unlike the traditional insurance company practice of using insurance premiums to fund long-term corporate loans, the two insurers are practicing spread lending by borrowing money in the commercial paper or Eurodollar markets and making shorter-term loans to business borrowers.

- In February 1983, Prudential-Bache Securities, Inc., in conjunction with Citibank (New York State), N.A., a bank subsidiary of Citicorp based in Buffalo, began offering an insured money market account called the "Insured Income Account," at Prudential-Bache's 200 offices.

- In January 1983, Travelers Corporation announced early that it plans to offer a cash management service to be marketed by its nearly 20,000 independent insurance agents.

- In March 1983, Travelers Corporation applied to offer insured accounts through its trust company subsidiary, Massachusetts Company.

- In March 1983, Prudential announced it was investigating the possibility of buying a bank.

E. RETAIL STORES

- In August 1981, First Texas Savings Association, Beneficial Corp's subsidiary, announced that it will install automatic teller machines in Kroger Company supermarkets throughout the state of Texas.

- On September 1, 1981, Sears, Roebuck & Co. announced that it was preparing for a large-scale move into the consumer finance business with the offering of a money market fund which will invest exclusively in U.S. Government securities and will be marketed to Sears' customer base in minimums of $1,000 with additional investments of $100 or more.

- In September 1981, Sears, Roebuck & Co., filed a registration statement with the SEC for the public offering of shares of a money market trust investing in U.S. Government securities. Dean Witter Reynolds, Inc., a brokerage firm expected to be merged into Sears by December 31, 1981, will be the trust's investment manager.

- In December 1981, Sears, Roebuck & Co. acquired Coldwell, Banks & Co., a real estate and related services firm.
- In September 1982, Kroger Company, the supermarket chain, and Capital Holding Corporation, an insurance company, launched a joint venture, the Kroger-Capital Holding Financial Centers, which offer a range of insurance products, money market and other mutual funds, individual retirement accounts, a credit card protection service, auto club membership, and a household goods inventory and registration service.
- In December 1982, Sears, Roebuck & Co. started to market its version of the money market account nationwide through offices of its brokerage subsidiary, Dean Witter Reynolds, Inc.
- In December 1982, J. C. Penney Co. announced it would set up financial service centers in five northern California stores through an agreement with First Nationwide Savings & Loan Association.
- In March 1983, J. C. Penney Co. announced it would take a substantial, though minority interest in First Bank System, Inc. which operates First Hand -- a home banking and videotex project.
- In March 1983, Sears, Roebuck & Co. announced it intends to use its newest subsidiary, Sears World Trade, Inc., to market worldwide sales of financial products and services offered by other Sears financial subsidiaries.
- In March 1983, Kroger Co. and Heritage Bank of Gwinett County, Georgia ($76 million in deposits) opened their first in-state banking office in a Kroger store in suburban Atlanta and expect to open 35 more.

F. NONBANK BANK SUBSIDIARIES OF NONFINANCIAL INSTITUTIONS

- In March 1981, the Federal Reserve Board concluded that Fidelity National Bank, California, a subsidiary of Associates First Capital Corporation, which in turn, is a subsidiary of Gulf & Western Corporation, was not a bank under the Bank Holding Company Act.
- In May 1981, the Federal Reserve Board concluded that Automated Financial Services, Inc., a subsidiary of Chrysler Corporation, was not a bank under the Bank Holding Company Act.
- In July 1981, Household International announced plans to acquire Valley Bank of Salinas, California.
- In August 1981, AVCO Financial announced plans to acquire Anaheim National Bank, California.
- In October 1981, Parker Pen Company announced the acquisition of First Deposit National Bank of New Hampshire.
- In 1982 Colonial National Bank, Delaware became a subsidiary of Teachers Service Organization, Inc.
- On August 9, 1982, the Comptroller of the Currency chartered a *de novo* national bank, Western Family Bank, N.A., which is a subsidiary of McMahan's Valley Stores.
- In February 1983, Beneficial Corporation received a national bank charter for Beneficial National Bank, Delaware.
- In February 1983, Resource Trust Company, Colorado, a subsidiary of Integrated Resources, Inc., received a Colorado bank charter.
- As of March 1983, Commercial Credit Corporation had an application pending in Delaware for First National Bank of Wilmington.
- In March 1983, Dimensions Financial Corporation submitted applications to the Comptroller of the Currency for 31 bank charters in 25 states.

G. ACTIVITIES OF FOREIGN BANKS

- In April 1981, Barclay's Bank became the first foreign bank to register and issue with the Securities and Exchange Commission to be offered in the American public markets.
- In June 1981, American Express International Banking Corp. issued $50 million Hongkong dollars ($9.1 million) of negotiable floating-rate certificates of deposit.
- In June 1981, Bermuda announced the formation of an international futures exchange which will sell seats to not only representatives in the United States but those in the Middle East, the Far East, and South America, as well as Continental Europe.
- On August 25, 1981, the Federal Reserve Board approved the application of Midland Bank Ltd. of London, England, to acquire 51 percent of the voting shares of Crocker National Corporation, San Francisco, California.
- In November 1981, a group of 27 British investors purchased about 5 percent of First Oklahoma Bank Corporation of Oklahoma City. The transaction was valued at $11.2 million.
- In November 1981, Texaco Financial Services, Inc. and London-based Charles Fulton Holdings, Ltd. announced the formation of a money market brokering company called Ful-Tex Euroservices, Inc., which will broker time deposits, money market instruments and foreign currencies between corporations and world financial markets. Texaco Financial is a wholly owned subsidiary of Texaco, Inc.
- In January 1982, the Federal Reserve Board, approved two applications for acquisitions of U.S. banks by foreign banking organizations -- Bancomer S.A., Mexico City, Mexico, to acquire Grossmont Bank, La Mesa, California, and Banco de Colombia, S.A., Bogota, Colombia to acquire Eagle National Bank (formerly Central National Bank of Miami), Miami, Florida. No competitive, financial, managerial or convenience and needs considerations were raised by either transaction. Bancomer only operates agency offices in New York and Los Angeles and Banco conducts no banking operations or other businesses in the United States.

Senator GORTON. Thank you, Mr. Baldwin.

Mr. Hammer.

STATEMENT OF FREDERICK S. HAMMER, EXECUTIVE VICE PRESIDENT, CHASE MANHATTAN BANK, N.A., NEW YORK, N.Y.; CHAIRMAN, GOVERNMENT RELATIONS COMMITTEE CONSUMERS BANKERS ASSOCIATION

Mr. HAMMER. Thank you, Mr. Chairman.

I am Fred Hammer, executive vice president of the Chase Manhattan Bank, N.A., and chairman of the Government relations committee and a member of the executive committee of the Consumer Bankers Association.[1]

Mr. Chairman, in analyzing the wide range of issues now facing the financal services industry, the CBA has found it essential to adopt a fundamental policy. This policy is to seek a regulatory structure that provides and assures parity of treatment among all types of consumer financial services providers. By parity, we mean an equality of opportunity for all consumer financial services providers, irrespective of history of their particular legal structure. We offer this position without any of the traditional "excepts" that in the past have accompanied similar "unequivocal" statements.

This single principle is the only sound guide for the deliberations of the committee this year and in the years to come. Only by using the concept of parity as a touchstone for legislative action will it be possible to move from the current industry structure—which is artificially fragmented and confused by product and geographic restrictions—to one that encourages informed market choices. Only by using that concept will it be possible to assure the efficient availability of the wide array of financial services now being sought by consumers. Of course, the best possible financial service to the consumer must be the ultimate objective of any system devised.

In response to the tempestuous events of the 1930's, Congress extablished a financial regulatory structure that ignored the workings of the market in favor of Government intervention. One of the legacies left by this intervention is a static framework of restrictions and requirements that, although covering virtually the entire financial industry when adopted, now imposes disparate treatment only on depository institutions.

Nondepository entities too numerous to mention are purchasing depository institutions or offering banklike services. Bank holding companies are affiliating with commercial enterprises in efforts to offer brokerage services and insurance operations. It simply is no longer constructive to attempt to define "a bank." That term has become meaningless as a shorthand reference to a set of financial services, making it essential to look to functions rather than structure.

In direct response to this new order, the Consumer Bankers Association has recently changed both its membership and its orienta-

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[1] The association is a nonprofit organization that was organized in 1919 to provide a voice for the consumer banking industry. Today the membership of the association consists of more than 500 commercial banks of all sizes that are actively engaged in extending consumer credit. Combined, the members of the association now hold over 70 percent of all consumer credit outstanding and over 80 percent of total consumer deposits held by commercial banks.

tion to reflect the new financial environment. We are welcoming as full members any federally insured depository institution, including savings and loan associations, savings banks, and credit unions. We are also inviting in all other consumer financial services providers that share CBA's goal of parity of treatment. Opening our membership will make it possible to escape the often disruptive intraindustry disputes that have marked the passage of legislation over several decades. Too long have the discussions and debates involving the relative rights of industry participants been characterized by internal bickering and one upmanship. The hour is simply to late for a continuation of the trivial intersegment squabbles that pit big banks against small banks, commercial banks against thrifts, and the entire category of federally regulated depository institutions against providers that do not take deposits.

In this approach, however, it is crucial to recognize that there is an existing imbalance. The current regulatory structure clearly places banks and other federally insured institutions at many competitive disadvantages. Let me cite just four examples:

The first involves the pervasive system of constraints on geographic location imposed by the McFadden Act and the Douglas amendment. New competitors not constrained by geographic limitations have been able to respond to the needs of the new consumer. CBA strongly opposes efforts to limit the activities of "nonbank banks" and others that have been forced to adopt innovative approaches in order to avoid obsolete restrictions. We do so even though we recognize that they will have a competitive advantage. Obviously, we earnestly hope that this will be only temporary and that there will be legislation to correct this imbalance in the very near future. In the interim, however, we are unwilling to abandon our basic touchstone of parity to redress such a transient detriment.

It is time for the elimination of these artificial barriers to enable depository institutions to operate geographically on an equal footing with all other providers of financial services. Acknowledging the difficulty in moving directly to that result, CBA would suggest a phased elimination, an approach similar to that used in 1980 for the phaseout of deposit interest rate ceilings.

The first step would be the elimination of all restrictions on the deployment of electronic terminals. This would merely provide parity to commercial banks, since Federal savings and loan associations and other financial services providers already are permitted to do this.

A second phase would involve expanding branching authority and enabling bank holding companies to acquire or initiate banks on a greatly expanded basis. One aspect would permit regional branching without regard to State laws or lines. In addition, nationwide branching would be permitted on the basis of agreements between or among individual States.

The final phase would be the repeal of the Douglas amendment and those portions of the McFadden Act that restrict branching activities.

The point is that the innovative market developments being witnessed today demonstrate that the current geographic restrictions have outlived their usefulness. It is the restriction and not the innovation that should be discarded.

A second example of the existing lack of parity involves the severe restrictions on the types of business activities in which depository institutions may engage. While other financial service providers have successfully penetrated traditional banking markets, depository institutions have been prevented from offering products and services sought by their customers.

In recent testimony before this committee, Treasury Secretary Regan announced the administration's intention to submit legislation similar to the proposal introduced in the last Congress. This proposal represents a significant step toward true deregulation and parity by authorizing bank holding companies to expand activities in such areas as insurance, real estate, and securities. With certain reservations, we believe that it comes close to meeting the objective of competitive parity among all providers of financial services.

The lack of product parity is particularly obvious in the area of insurance activities. The insurance industry now offers its customers traditional bank products such as IRA's and consumer and commercial loans. As in all other cases, CBA does not favor imposing restrictions on insurance companies that provide financial services. Instead, we urge Congress to act swiftly to remove regulatory restraints on insurance activities of depository institutions in order to establish competitive parity.

A third example of lack of parity involves the duty of some but by no means all service providers to maintain sterile reserves with the Federal Reserve System. We urge Congress to enact legilsation to provide that a reasonable rate of return be earned on reserves, at the very least for those held on the money market deposit account, the super NOW, and any future accounts authorized by DIDC.

A fourth and final example involves the lack of specific authority for leasing activity by national banks. An amendment to the National Bank Act, to make it conform with the powers held by Federal savings and loans, is needed to assure fair and equal treatment in offering this increasingly important consumer product.

CBA believes that the new environment described above and the need for legislation illustrated by these four examples demonstrate that thoughtful but rapid congressional action is essential.

In the past, both the industry and Congress have approached the legislative process in a now familiar pattern characterized by intraindustry squabbles, tinkering with existing constraints, and attempting to weigh and measure various interests of a diverse community of service providers. As a result, the recent history of banking legislation has reflected the mere ratification of major structural changes occurring in the financial services industry well before being sanctioned by Federal legislation. We urge this Congress to undertake a new direction in analyzing the entire financial services industry—a legislative approach founded on the identification and use of principles that permit the development of an efficient and sound financial system. We would suggest at least the following guiding principles.

First and foremost, the guiding principle must be parity—that means equality of treatment regardless of how that may cut on a particular issue.

Second, product and geographic limitations affecting both depository and nondepository institutions should be ended.

Third, regulatory involvement should be limited to policing the narrow range of financial activity that affects the deposit function or that creates real dangers to the safety and soundness of the financial system.

Fourth, there should be a new examination of efforts to identify expanded and appropriate information to be disclosed which will not mislead but will assist the market in making informed choices during an age of reduced regulatory involvement.

Fifth, there should be a single set of compliance requirements devised by a single Federal rulemaker with obligations applying with equal force to all those competing in a similar market.

As these and other principles are identified, it is important to recognize that they must be founded on social and economic effiencies, and not on the imposition of semipermanent Government statutues and regulations that do not sit well on the shifting rock of the American financial experience.

Finally, Mr. Chairman, there are other issues discussed in our written statement that, although not prompted by the concept of parity, are of great importance to CBA. The most important of these relates to the removal of artificial price controls in the form of usury ceilings. These ceilings distort the marketplace, resulting in unfair treatment for consumers and financial institutions alike. Recent substantial deregulation of liabilities makes the need to remove these inefficient asset limits even more compelling.

We appreciate having had the opportunity to testify today, and I would be pleased to answer any questions.

[Complete statement follows:]

TESTIMONY OF

THE

CONSUMER BANKERS ASSOCIATION

SUMMARY

Parity

The Consumer Bankers Association (CBA) believes that the new financial industry system should be characterized by parity, the equality of opportunity for all providers of consumer financial services. The concept of parity requires:

- the elimination of product and geographic limitations affecting depository and nondepository institutions;
- a minimum of regulatory interference; and
- unified rulemaking authority within one agency applicable to all institutions competing in the consumer financial services market.

In order to achieve this goal, we urge congressional action in the areas summarized below and explained in depth in our testimony.

McFadden-Douglas Expansion of Electronic Fund Transfer Capability

The problems created by current geographic restrictions on the provision of consumer financial services can ultimately be solved only by the repeal of McFadden-Douglas. However, in acknowledging the difficulty in moving directly to that result, CBA would reluctantly suggest the consideration of a phased elimination of geographic restrictions.

Proposal for Creating Geographic Parity

We suggest that the first step be legislation that would permit the deployment of electronic terminals on a nationwide basis. This legislation would include an amendment to the National Bank Act permitting automated teller machine (ATM) deployment by national banks on a nationwide basis. It would also include independent legislation permitting federally insured depository institutions (state-chartered institutions) to deploy ATMs nationwide. This would provide parity for commercial banks, since federal savings and loan associations and other financial services providers currently have this capability.

A second phase would require amendments to both the McFadden Act and the Douglas Amendment. One amendment would permit regional branching (without regard to state laws or lines) and, as is now permitted for bank holding company expansion, branching based on agreements between or among individual states that permit out-of-state institutions to branch in host states. It would also involve changing the Douglas Amendment to enable bank holding companies to acquire or initiate banks on a national basis.

The third and final phase would be the repeal of the Douglas Amendment and those portions of the McFadden Act that restrict branching activities.

In conjuction with this overview, we urge the following:

Deregulation of Bank Products and Services

We support the concept of giving depository institutions further specific authority in areas such as insurance, real estate and securities. Though CBA has certain reservations regarding the Treasury proposal, we believe that this proposal comes closest to meeting the objective of competitive parity among providers of financial products and services.

Insurance

The insurance industry has responded to the needs of its customers by offering a wide range of investment and savings products. CBA urges Congress to remove restraints that prohibit financial institutions from providing a full range of insurance products and services, so that they too can respond to customer demands and competitive forces.

Usury Preemption

CBA fully supports the efforts of the Chairman of this Committee and others in Congress to provide for the federal preemption of state-imposed usury ceilings. These ceilings distort the marketplace, resulting in the disparate treatment of consumers and financial institutions. In addition, recent substantial deregulation of liabilities makes the need to remove the limits on assets even more compelling.

Unified Rulemaking

CBA recommends that unified rulemaking authority for consumer financial services be given to the Federal Reserve Board. Though enforcement authority would remain with each respective line agency, regulation writing by one agency would remove the present problems caused by inconsistent and duplicative interpretations.

Leasing Powers

Section 330 of The Garn-St Germain Act and the FHLBB implementing regulation permit thrifts to offer a wide range of leasing products without the restrictions presently imposed on banks and bank holding companies. CBA asks that Congress amend the National Bank Act to ensure competitive equality in this area.

Earnings on Reserves

We urge that Congress enact legislation to provide that a reasonable rate of return be earned on reserves held on the MMDA, the Super-NOW and future accounts authorized by the DIDC. The earnings should be passed through to depository institutions.

DIDC

In the pursuit of parity, we urge the DIDC to remove all remaining interest rate ceilings; to reduce and eliminate (by January 1, 1984) initial and balance requirements of the MMDA and Super-NOW accounts; and to authorize an unlimited-transactions account for businesses at its June 28, 1983 meeting.

CBA asks that Congress also address the following legislative changes we believe to be necessary for the ongoing viability of the consumer financial services industry.

Amendments to the Consumer Leasing Act (CLA)

CBA generally supports the recently introduced legislation that proposes to amend the CLA. We believe that it is necessary to reduce the number and complexity of the presently required disclosures. We urge Congress to reexamine the civil liability provision as well as the statute-of-limitations rules and the measure of damages.

Truth-In-Lending Act

In view of the massive revision of this Act in 1980, we do not seek further changes in disclosure requirements. However, we urge Congress to consider the following amendments:

1. Relation to state law. We ask that Congress review the standard presently permitting the inclusion of state disclosures that are similar, different and duplicative of the federally mandated disclosures.
2. Civil Liability. We believe that the current civil liability section should be modified. Courts should be given the discretion to review all the disclosures subject to the civil liability penalty provision, and be allowed to award or deny recovery based on whether or not the transaction is in substantial non-compliance with the purpose of the TILA.
3. Rescission. The required three-day rescission period for direct loans secured by a consumer's dwelling has resulted in consumer irritation and unjustified costs to financial institutions. Since this right is rarely exercised, CBA urges the Committee to exclude direct loans from the rescission requirement.

Criminal Liability in Connection with Credit and Debit Cards

CBA believes that the dramatic increase in certain types of crimes associated with these cards necessitates a comprehensive amendment to Title 18 of the United States Code. However, minor amendments that would close loopholes in the existing criminal provisions in the Truth in Lending and Electronic Fund Transfer Acts would ensure prosecution for these crimes.

The first amendment would recognize that the use of account numbers, without actual possession of the card, would be subject to the criminal provisions. The second amendment would permit prosecution when the aggregation of transactions and the combined use of cards reached the $1,000 floor as provided in the federal statute.

Delayed Funds Availability

CBA recognizes the problems associated with delayed funds availability. We strongly recommend voluntary disclosure by depository institutions of policies that articulate the reasons for delays.

TESTIMONY OF THE CONSUMER BANKERS ASSOCIATION
BEFORE THE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE
ON THE DOMESTIC FINANCIAL SERVICES INDUSTRY OVERSIGHT HEARINGS

I am Frederick S. Hammer, Executive Vice President of The Chase Manhattan Bank, N.A. and Chairman of the Government Relations Committee and a member of the Executive Committee of The Consumer Bankers Association (CBA).(1)

The Consumer Bankers Associations appreciates the opportunity to participate in these far-reaching hearings. You have invited comments on an exceedingly wide range of issues that now face the financial services industry. We have analyzed a significant number of these issues and have developed specific positions with respect to them. In devising these positions, however, we have found it essential to adopt a fundamental approach, a guiding principle if you will. We believe that this guiding principle must be to permit and assure parity of treatment as among all types of consumer financial services providers.

CBA submits that this single principle is the only sound guide for the deliberations of this Committee this year and in the years to come.

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1. The Association is a nonprofit organization that was organized in October 1919 to provide a voice for the consumer banking industry. Today the membership of the Association consists of more than 500 commercial banks of all sizes that are actively engaged in extending consumer credit. Combined, the members of the Association now hold over 70% of all consumer credit outstanding and over 80% of total consumer deposits held by commercial banks.

Only by using that concept as a touchstone for legislative action will it be possible to move from the current industry structure — which is artificially fragmented by product and geographic restrictions — to one that encourages informed market choices. Only by using that concept will it be possible to assure the efficient availability of the wide array of consumer financial services now being sought by consumers.

Many of the problems that our industry faces are the direct result of laws passed in a vastly different time. In an attempt to respond to the tempestuous events of the early 1930s, Congress established a financial regulatory structure that reflected a basic fallacy that government intervention could best decide what areas should be served and what products provided. In that process, the workings of the market were simply ignored in favor of government decision-making.

Natural forces, be they the workings of the market or nature itself, do not respect the attempts of government to impose itself on them. A recent example can be seen in the legislation adopted in your home state, the state of Utah, that prohibited the Great Salt Lake from rising higher than 4,202 feet above sea level. Despite the legislative mandate and appropriate legislative history, the Great Salt Lake broke that law on February 1 of this year, presumably becoming one of the largest and most liquid criminals in the country. We point this out merely because it typifies the inability of government to control forces that fall beyond its power. This is no less true of the operation of the market than of nature herself. The government is unable to control forces that simply fall beyond its power. We believe that the role of government in regulating the financial markets must be reexamined, and that parity must be the key word in structuring the new rules that should apply to all that offer similar services.

One of the legacies left by this historical intervention by government is a framework of restrictions and requirements. Although essentially covering the entire financial services industry when first adopted, it now imposes disparate treatment on only an increasingly small segment of that industry. As a result of that static regulatory structure and the dynamics of the marketplace, depository institutions and other services providers are afforded very different treatment, depending on their legal structure. CBA urges Congress to recognize this lack of fair treatment and to remedy it. Only by providing equitable treatment is it possible to assure the development of a strong and vital financial services sector.

The Changed Environment — CBA's Role

In recognition of the changing face of the industry, The Consumer Bankers Association announced today that it was changing both its membership and its orientation to more appropriately reflect the new financial environment. Too long have the discussions and debates involving the structure and relative rights of participants of this industry been characterized by internal bickering and one-upmanship. The hour is simply too late for a continuation of the inter-segment battles that pit big banks against small banks, commercial banks against thrift institutions and the entire category of federally regulated depository institutions against providers that do not take deposits.

To assure a new voice for this reconfigured industry, CBA has undergone its own reconfiguration that will enable it to advance the interests of this entire array of service providers. Consistent with its new direction, CBA is welcoming as full members any federally insured depository institution, not only banks, but also savings and loan associations, savings banks and credit unions. Full membership is limited to depository institutions that are federally insured because of the continuing unique problems that are faced by this element of the integrated industry. We welcome as associate members, however, with full rights of participation, any providers of consumer financial services that wish to join in a collective effort to develop a financial system based on parity of treatment among all providers.

Opening membership to all of these providers makes it possible to better serve all segments of the industry and to escape the always spirited but sometimes disruptive intra-industry disputes that have marked consideration and passage of legislation over the past several decades. Collecting all of the participants in the field will enable them to seek with a single voice, a parity of treatment among all segments of the industry in order to produce a more responsive and stable financial industry — a financial industry that will be free to use its time and energies to develop and deliver consumer financial services rather than engage in internecine conflicts.

We strongly believe that a rapid recognition of and adjustment to the new financial environment will free economic forces to engage in productive endeavors. This will be a major step forward in providing reasonably priced and widely available consumer financial services.

With these changes in membership policy and overall focus and approach in mind, our testimony will address a variety of issues of vital importance to CBA and its members. First, we will discuss the concept of parity, offering some background on the disparate treatment among depository institutions and other financial services providers, examining historical changes that have, in our view, rendered that treatment obsolete and discussing some of the ramifications of the concept of parity. Next, we will present an overview of a number of legislative issues that CBA feels that Congress should address in order to implement the broad goal of parity. These issues include geographic restrictions affecting banks and bank holding companies, and restrictions on the products that can be offered by banks and bank holding companies. We will also discuss certain issues that, although not prompted by the concept of parity, are of great importance to the members of the Association. These issues include revisions in the Consumer Leasing Act, and limited amendments to the Truth in Lending and Electronic Fund Transfer Acts.

Parity — Its Meaning In The Consumer Financial Services Industry

CBA believes that it is essential that the new financial industry order be characterized by parity. By that we mean an equality of opportunity for consumer financial service providers of all types, irrespective of history or their particular legal structure. We offer this as our position without any of the traditional "excepts" that have accompanied similarly "unequivocal" statements made by various segments of our industry.

As adopted by CBA's Board of Directors, this Association's charge is to seek

> "parity among all providers of consumer financial products and services, in which such vendors shall receive competitive equality and be subject to the same regulations and statutes so that no competitive advantage or disadvantage exists among them."

We recognize that many will question our willingness to permit competitors to enter what historically have been areas left exclusively to traditional depository institutions. Contrary to these reactions, we welcome to our industry new participants that are prepared to follow the same rules and restrictions that we must observe.

In urging parity, we have often referred to the giant strides being made by nontraditional financial services providers in packaging and delivering financial services. Though in some respects we would prefer to live in the cocoon-like safety and near-monopolistic environment that existed decades ago, we believe that the entrance of these providers will contribute to a stonger and more vital financial services industry.

While we welcome new participants, however, we acknowledge and we ask the Committee to recognize that there currently exists a lack of parity among the various participants in the consumer financial services industry. The current imbalance must be remedied.

We do not believe that the remedy is simply to impose greater restraints on those that are not now regulated. We do not suggest that current opportunities be reduced for any of the many participants in the system. We view the existing advantages of nondepository participants as a response to market-driven forces seeking to evade an obsolete regulatory framework, rather than as a result of clearly enunciated public policy. We believe that the ultimate answer must be a deregulated financial services system that offers its customers services and conveniences that are determined by the market and not by government regulation.

The Changed Environment — The New Financial Market

The marketplace is rapidly eroding the tenuous line between banking and commerce. Nondepository entities are purchasing banks or offering bank-like services. Bank holding companies are affiliating with commercial enterprises, though they remain subject to close scrutiny by federal regulators. Though examples abound, it may be helpful to look at three specific competitors that have recently entered the scene.

The first competitor has a savings and loan association in Redding, California, and a national bank in New Hampshire. This competitor also operates a life insurance company in Arkansas and offers stock and brokerage services through arrangements with a discount broker. The company has expressed its intentions to market a complete array of consumer financial services on a national basis using these companies and telephone and mail communication. This financial giant is the Parker Pen Company.

A second example is provided by a company that operates a money market mutual fund in excess of $10 billion that offers investors — or we would suggest depositors — the opportunity to draw third-party drafts on the accounts. It has a life insurance company in New York through which it markets a full range of insurance products. It has a state bank in New Jersey and is creating a national bank in New York. In addition, it is in the process of acquiring a savings and loan association in Virginia to enhance its capability to make real estate loans. This financial conglomerate is the Dreyfus Corporation.

A third example is a national financial organization that has more than 2,000 branches and has acquired a savings and loan asociation, a full service securities brokerage firm that includes money market fund investment opportunities, a mortgage company, a nationwide real estate broker and an insurance company that can offer all forms of insurance. Through inhouse "branches" within its stores — actually "one-stop financial shopping" facilities — it is able to offer a complete array of financial services both for consumer and corporate customers. This financial behemoth — originator of the "sock to stock" concept of marketing — is Sears Roebuck.

Other examples demonstrate the breadth and depth of these developments. Household International, the parent of Household Finance, operates a seven-branch national bank and over 45 thrifts and industrial banks in four states. Beneficial Corporation offers MasterCard and Visa, as well as other services, through Beneficial National Bank. As Beneficial's annual report states happily, "In reality, as well as perception, 'at Beneficial, you're good for more.' Compared to many of our banking and thrift industry competitors, we are relatively free of restrictive regulation."

Merrill Lynch moved into the consumer financial services market with its "Cash Management Account," through which savers can earn market rates on idle cash, purchase securities and obtain cash advances. The American Express Company's merger with the brokerage firm of Shearson Loeb Rhodes, and Shearson/American Express's acquisition of The Boston Company, has provided another opportunity for combined brokerage and cash management. Customers can gain access to their combined accounts by use of the American Express Gold Card.

In other innovations, McMahan, a California furniture chain of over 70 stores, obtained approval to open national bank branches in its stores. Kroger, the grocery store chain, has announced the opening of financial centers in its supermarkets. The Travelers Insurance Company intends to market a cash management service through its insurance agent network.

Some other examples are of banks or their holding companies expanding their traditional operations, although not without a full measure of regulatory and judicial resistance. Last year, BankAmerica acquired Charles Schwab & Co., the nation's largest discount brokerage firm. Security Pacific obtained approval to set up its own discount brokerage subsidiary in California, and recently obtained approval to acquire a discount brokerage firm based in Memphis. Citicorp and First Interstate have announced their intentions to buy South Dakota banks in order to engage in insurance operations.

Perhaps most startling is the plan by a group of investors, known as Dimension Financial Corp. to establish 31 national banks in 25 states to offer consumer financial services at a reduced price. The group's applications, currently pending before the Comptroller, will not be affected by the recently-announced moratorium.

The financial services industry is involved in a great deal of cross-industry activity at the present time. Though banks and their holding companies have taken part in these activities and have made advances, it is clear that they have only been achieved after significant corporate maneuvering and time-consuming and costly regulatory and judicial scrutiny. Even those activities that are permissible under existing statutes remain subject to dispute, thereby unsettling the expansion process and deterring further activities regardless of their economic soundness. In many cases, these new developments remain subject to structural or technical niceties that result in inefficiency and continue the failed concept of institutional choices being decided by government fiat. Thus, though there have been limited successes, they continue to be subject to the same uncertainties and inefficiencies that characterize depository institutions' regulation generally. The basic impairment that prevents depository institutions from engaging fully and fairly in the financial services market is an essential lack of parity.

Parity — Its Absence for Depository Institutions

Nondepository institution service providers clearly place commercial banks and other federally insured depository institutions at a competitive disadvantage. We would not suggest that legislative efforts be undertaken to curb or limit their ability to perform these services. Rather, we would urge that action be taken to enable us to provide similar products on an unlimited geographical basis, and be subject to the same rules that they are.

Currently, the regulatory structure of the financial services industry contains numerous examples of the lack of parity among the various participants. We believe that Congress should address these obsolete and unfair provisions that frustrate the attainment of parity of treatment. Though there are others, the following examples provide some indication of the nature and scope of the problems being faced by regulated depository institutions.

The first involves the pervasive system of constraints on geographical location. Although the subject of numerous exceptions and evasions — including national mail and telephone delivery mechanisms, loan production offices and commercial lending activity, all of which effectively avoid these restrictions by careful contrivance — these anachronistic restrictions must be removed.

The existing limits on branches were initially devised in 1927, as part of the McFadden Act, and were substantially broadened by amendments made in 1933. Ironically, when both these enactments took place they expanded permissible national bank branching activities partially as a result of a congressional recognition of the changed society being served by the banking industry.

The events of the last five decades have radically changed the face of the nation being served by the financial services industry. We have gone from a heavily rural to a heavily urban and suburban society. We have also become a society constantly on the move — frequently changing jobs and homes, traveling for business and for recreation.

All of these social and demographic changes have had a direct impact on the types of financial services sought by consumers and the appropriate delivery mechanisms to be used in providing them. New competitors not constrained by geographic limitations have been able to identify and meet the needs of the new consumer.

At the same time, federally regulated depository institutions have been forced to use various contrivances in an only partially successfully effort to continue to provide financial services. The creation of shared electronic networks that permit some but not all banking functions, the use of state havens from which consumers are encouraged to engage in telephonic and mailed financial services and other devices are hallmarks of the inefficiencies forced by the perpetuation of geographic restrictions formulated in a vastly different time.

Further demonstration of the obsolescence of these limits is provided by the recent activities on the part of a few states to permit interstate bank acquisition. The states of Alaska, Maine, South Dakota, Delaware, Virginia and Massachusetts have realized that their own boundaries do not serve well as dividing lines for the provision of financial services. They understand that the markets are now being served routinely across these lines. Though CBA welcomes the advent of these opportunities, we question whether it is prudent to develop a national policy on a piecemeal, state-by-state or regional basis. We believe that a congressional analysis of this issue that views the matter from a nationwide perspective is imperative, and that to be effective it must take place immediately or risk being overtaken by events.

Perhaps as important as the obsolescence of these geographic restrictions is the fact that, in may cases, they simply do not work. Through legitimate avoidance techniques designed to recognize the operation of the market, basic objectives are being achieved despite the restrictions. The restrictions do, however, impose a significant cost in terms of efficiency. That cost is initially borne by the system but ultimately paid for by the consumers who use that system. A number of examples are available, such as use of the loan production offices and shared interstate electronic networks that are a fact of life today.

By the 1950's, as the market began to recognize the need for expanded and more geographically diverse financial services, banks were forced to use the vehicle of multiple bank hold companies. Seeing this as an evasion of the rules set in 1933, Congress responded by prohibiting these activities. Nonetheless, the market continued to operate, and further legislative and regulatory activities were undertaken to prevent the inevitable workings of the free enterprise system.

Government response to these changes seems not to have developed much further from that date to this. This is illustrated in the closely related areas of product differentiation, and it also bears upon avoidance of geographic limits. The Dimension Group mentioned earlier is an example of the ingenuity of the market to develop in ways that avoid governmental restrictions, this time by forming so-called "nonbank banks." In effect, by following current law and limiting their activities, Dimension proposes to operate 31 banks in 25 states. It will become a multi-state bank holding company, something thought to have been prohibited absent specific state approval since 1956.

These nonbank banks have developed from an application of a literal, but entirely proper, reading of the applicable statutes. Though the regulatory response has been mixed at best, certain regulators wish to impose restrictions on them. We strongly oppose those efforts. We do so despite a clear recognition that the use of these mechanisms will provide some advantage to those against whom we compete. We are unwilling, however, to abandon our basic touchstone of parity to redress such a transient detriment.

Rather, nonbank banks and other innovative market developments demonstrate conclusively that the current restrictions have outlived their usefulness, and that it is the restriction and not the innovation that should be discarded. If there is to be any meaningful capability of the financial industry to operate in the market, the constraints that force these corporate contortions must be removed, and the obsolete industry walls torn down.

In addition to the troublesome geographic restrictions, several others are worthy of note. For example, on the basis of events that racked the economy of the early 1930s, an attempt was made to erect a wall between the types of products and services that could be offered by commercial banks and those that any other participant in the economy could offer. That wall should be removed in its entirety. After five decades of an artificial separation among different types of financial services, we are now past the point at which commercial banks should be free to offer a full array of products determined not by government fiat but by market response. Commercial banks should no longer be prohibited from offering securities services, insurance products and any other type of products or services that a specific institution determines that it wants to offer. Concerns about integrity of the heavily insured depository institutions industry can still be met to the extent necessary, but government can no longer justify the prohibitions so hastily put into place in 1933.

A second example is that only depository institutions are required to maintain sterile reserves with the Federal Reserve System. Although there is a growing debate as to the efficacy of reserves in this regard, they are believed by some to be an important tool of monetary policy. This mechanism, regardless of its role in implementing monetary policy, is paid for exclusively by the federally regulated depository institutions industry although, in fact, it is their customers who actually bear that expense. We believe that this clear inequity must be resolved, if not by reexamination of the desirability of or the need for requiring reserves in the first place then by following the precedent set in 1980 with respect to supplementary reserves and providing that some return be paid on these reserves.

A third and final example involves required adherence to a subjective statutory mandate to assist in meeting a community credit need. Though, in fact, the obligations set in the Community Reinvestment Act (CRA) simply restate what bankers would consider to be good business, not only the effects of CRA's potential for abuse but the lack of coverage of other services providers make it an unfair additional requirement. That provision, which has now served an alert function, should be removed, and the market response carefully monitored.

In these and other areas it is essential that parity of treatment be assured. A failure to address these and similar issues will perpetuate and enlarge the disadvantages now placed upon one class of service providers in a new environment populated by many that offer identical products and services but without these handicaps.

The Changed Environment — The Need For Congressional Response

Virtually every witness who has appeared before the Committee has commented on the dramatic changes in the regulatory and competitive landscape that have occurred over the past decade and seem to be accelerating on a month-by-month basis. We believe that simply having a collective recognition of these events is not enough. It must be followed by decisive congressional action that responds to these events. We join with the Chairman in his consistent recognition that the recent history of banking legislation has reflected the mere ratification of major structural changes occurring in the financial services industry well before being sanctioned by legislative pronouncements.

A mere acknowledgment of the dramatic changes we are witnessing today is of little benefit to a market that is expending untold amounts of resources and energy attempting to devise exotic mechanisms through which to evade the existing regulatory structure. Corporate contortions do not boast of any socially or economically redeeming features other than to demonstrate once more that market forces inevitably will stimulate the level of ingenuity necessary to evade federal regulations. Rather, they serve to perpetuate the image of a regulated industry whose various constituent parts careen back and forth and from regulator to regulator seeking to identify the path of least resistance to avert proscriptions that have not been the subject of serious congressional review for the past half century.

In seeking congressional action in light of the recognition of change, we have found it difficult to conjure up cogent arguments that could be advanced by those who believe that legislative changes should not at the very least keep up with the realities of the marketplace. Dramatic shifts in the composition and activity of new and changed financial services providers and the clear and adverse impact on certain segments of the industry have all been exhaustively documented.

The question that remains is why that evidence remains inadequate to move the legislative process.

The answer can be found by looking to the recent past, in which banking legislation needed to have as a driving force some form of intra-industry conflict in order to precipitate compromises and virtually assure that major legislation would not move forward unless each segment got its share, but no segment got too much. As economic and political events affected the process, various segments did more or less well based in substantial part on the nature, scope and imminence of potential disaster and the ability of the various sectors to identify and verbalize complex issues with an ease and directness that would place those issues into a workable context for political debate.

For many years, the principal driving force involved the ability of thrift institutions to pay a slightly higher rate of interest on their deposits than that permitted to be paid by commercial banks. That one vehicle, and issues directly related to it, played a significant part in the shape and timing of virtually every major legislative pronouncement affecting depository institutions that was adopted in the past decade and a half.

The differential debate has been simply out-distanced by economic events such as those outlined above. Nonetheless, the legacy of the legislative process formed in this context continues to hang over not only these hearings, but any future legislative developments. CBA believes that it is important to change the approach to legislative action in the financial services area that has characterized — and unduly distracted from and distorted — previous legislative debates.

The Changed Environment — A Suggested Congressional Approach

In the past, both the industry and Congress have approached the legislative process in a now-familiar pattern characterized by intra-industry squabbles, tinkering with existing constraints, attempting to weigh and measure the interests of an increasingly diverse community of service providers and undertaking policy formulation on the basis of judgments as to the relative plusses and minuses as among affected industry segments, rather than by attempting to fashion a financial system that follows substance. CBA believes strongly that neither the members of the financial industry nor the consumers they serve can afford this legislative approach any longer.

We urge this Congress to undertake a new analysis of the scope and shape of the entire financial services industry. At the risk of being accused of uncharacteristic naivete, CBA respectfully urges the consideration of a new legislative approach that is be founded on the identification and use of principles that permit the development of an efficient and sound financial system.

It is imperative to begin the analysis with a clean slate. The fact that one or another segment now has a slight advantage or disadvantage is wholly irrelevant. Many of the problems faced today are the direct result of attempts to reconcile in fairly minor ways a complex set of statutory restrictions without in each case joining the larger issue as to whether that or any other structure ought to be in place.

We do not, by this suggestion, mean to understate the magnitude of the task. We understand that, in a complete examination of the industry and its regulatory constraints, familiar concepts of geographical and product differentiation based on long-past market experience would no longer serve as helpful benchmarks for action. Instead, each premise, each power and each player would be subject to an exacting inquiry concerning its role in a new financial system.

The increasingly rapid market erosion now being experienced by depository institutions — caused not by competitive pressures but by obsolete government restrictions that adversely affect only this industry segment — must be reversed. This reversal will come only when Congress devises a system with the structure and flexibility necessary to permit and encourage an effective financial services industry for the coming decades.

In designing this new system, we would suggest several guiding principles.

First and foremost, as discussed earlier, the guiding principle must be parity. Not just parity when pursuing a particular goal which means that "we" obtain an advantage over "them," but parity that means equal treatment however that may cut on a particular issue.

Second, product and geographic limitations affecting both depository and nondepository institutions should be ended. Financial services activities that the market demonstrates will support should be encouraged. Those that wish to offer a broader range of services and products should be encouraged to do so. The entire array of financial service products should be available for all types of providers to offer, and they should be available whenever the providers believe it is efficient to offer them.

Third, regulatory involvement should be carefully limited to policing the very narrow range of financial activity that affects the deposit function or that imposes a danger for the safety and soundness of the banking system. This would permit a broad range of services to be offered, enabling the market to shape the industry with a minimum of paternalistic regulatory interference. In this regard, careful scrutiny should be given to analyzing the rationale behind the regulation of the financial services system.

Fourth, there should be a revitalization of efforts to identify the appropriate information to be disclosed to the public. Appropriate information that does not confuse, but rather informs, will enable the consuming and investment public to make sounder decisions.

Fifth, there should be a single set of compliance requirements devised by a single regulator with obligations that apply with equal force to all those competing in a common or similar market.

Obviously, these are only some of the major principles that must be taken into account. As these principles are identified, however, it is important to recognize that they must be founded on social and economic efficiencies, and not on the imposition of government statutes and regulations that do not sit well on the shifting rock of the American financial experience.

In addition to these efforts at the federal level, Congress should protect the efforts of several states that have recognized the realities of the new diversification in the financial services arena. These initiatives range from the abolition of archaic usury laws to the reconsideration of appropriate services on the part of state banks. These laudable efforts have illustrated the new realism and direction of parity that we believe is long overdue at the federal level.

Pending widespread recognition of the need for that movement at the federal level, we believe that the states should be actively encouraged to continue in their efforts to experiment in permitting a wider variety of financial service providers to operate within them. In no way should those operating under these state laws be restricted by federal regulations that seek to impose a more narrow view of the appropriate role of financial institutions.

We strongly believe that a rapid recognition of and adjustment to the new financial environment will free economic forces to engage in productive endeavors. This will be a major step forward in providing reasonably priced and widely available consumer financial services.

THE MCFADDEN-DOUGLAS ISSUE: THE PROVISION OF FINANCIAL SERVICES FREE OF GEOGRAPHIC RESTRAINTS

For over five decades federal law has explicitly limited the geographic basis on which national banks, and later, bank holding companies, could offer financial services. Despite enormous changes in the society being served and the financial markets themselves, these restrictions have continued unchanged for many years. They are particularly inappropriate in view of the emergence of a large number of competitors unaffected by them. This disparate treatment is the direct result of the McFadden Act, affecting national bank branching activity, and the Douglas Amendment to the Bank Holding Company Act, which relates to the interstate activities of bank holding companies.

In a contemporary analysis of these laws it is crucial to emphasize the impact of the dramatic changes that have occurred in the composition of the financial services industry. Those changes have a direct bearing on the clear obsolescence of geographic restrictions. When originally devised, these statutes were substantially justified on the basis of "parity" between the two almost exclusive providers of financial services — national banks and state-chartered banks. The significant expansion in the nature and number of participants in this industry, however, has totally undermined the factual foundation upon which this legislative determination was based. Though arguably the concept of parity was satisfied fifty years ago when these two types of financial services providers were afforded relatively equal treatment, that simply no longer applies in today's expanded financial services industry.

These obsolete restrictions must be removed in order to end the unfair treatment of depository institutions and to enable them to compete on the basis of parity with other consumer financial services providers. CBA strongly believes that these statutory provisions should be repealed at once. In recognition of political realities, however, we will advance a concrete proposal for the phased elimination of these constraints.

Background

The McFadden Act. During the first half of the nineteenth century, despite heavy anti-bank sentiment, there was little legislative activity designed to limit bank branching. The First Bank of the United States was organized in 1791 in Philadelphia and established branches in a number of cities around the new country. The legislative debates that accompanied the National Currency Act in 1863 and the National Bank Act in 1864 revealed no concern about banks expanding their economic bases through unrestrained branching. That lack of attention is fully understandable in light of the nature and shape of the market then being served. In a primarily rural economy, consumers expected to seek products and services of all types from the nearest population center. There was no expectation that financial or any other services could be any more conveniently located than that.

Perhaps as a function of the understandable lack of congressional concern, early court decisions interpreted the National Bank Act to prohibit branching by national banks. The issue was a relatively unimportant one, however, since state banks were generally similarly limited to one office. That fact, combined with liberal chartering policies, resulted in a record number of bank offices throughout the country. In view of this proliferation of banks, the financial needs of businesses and consumers were met and there appeared to be little demand for added services through branching systems.

By the early 1900s, state banks were beginning to seek and obtain expanded authority to branch in order to serve their geographic areas. Competitive pressures on national banks resulted in the so-called "teller's window" rule, adopted by the Comptroller in 1922, under which national banks could operate limited-service offices and agencies in the city in which they were located.

This rule, together with the increasing branching authorization given to state-chartered banks, led to the passage in 1927 of the McFadden Act. Often overlooked is the fact that this now-restrictive legislation actually *expanded* the branching powers of the national banks involved when it was passed. The McFadden Act had as dual purposes an increase in the level of competitive equality between national and state-chartered banks and a limit on the branching activities of state-chartered banks that were members of the Federal Reserve. It achieved the first result by granting national banks explicit authority to open branches in the cities in which they were located if state-chartered banks had similar authority. At the same time it prohibited all member banks, whether federally or state-chartered, from establishing out-of-town branches. It also required them to relinquish any new branches established outside their city limits or acquired as part of a merger with state-chartered nonmember banks.

One effect of the McFadden Act was to reopen the issue of branch banking in the state legislatures. During the ensuing two or three years a number of states enacted restrictions on branching within their states that applied not only to state-chartered banks but also, through the operation of the McFadden Act, to national banks. By 1930, the laws of 22 states prohibited branching.

Following the Depression and the collapse of a number of banks, however, it was seen that unit banks fared relatively poorly in the struggle to survive as compared to banks with branches. As a result, between 1930 and 1935, 15 states either liberalized existing restrictions or enacted liberal branching laws for the first time. One impetus for this activity was the hope that failing banks could be merged with, or possibly become branches of, stronger institutions.

There also was a marked change in congressional attitude. Among the results from this was an amendment to the McFadden Act adopted as part of the Banking Act of 1933 (commonly known as the Glass-Steagall Act). That amendment permitted national banks to branch anywhere within a state that a state-chartered bank could branch. The irony bears repeating that a law whose original intent was to liberalize and encourage branch banking is currently a major obstacle to geographic expansion by banks.

The Bank Holding Company Act (and its Douglas Amendment). During the 1940s and early 1950s bank holding companies began to develop, in part to avoid the restrictions on intrastate and interstate branching imposed by state laws and the McFadden Act. Multibank holding companies generally owned several banks within one state, but some also owned banks across state lines. These developments were largely the result of market pressures. As metropolitan areas increased, the economy continued to expand and new financial products were developed. As regional and even national banking markets emerged, however, fears were expressed about undue concentration in the banking industry.

These concerns, and a desire to regulate and regularize the holding company form of organization, led to the passage of the Bank Holding Company Act in 1956. Among other things, this statute addressed the issue of interstate expansion of bank operations through the so-called Douglas Amendment, Section 3(d) of the Act. The Douglas Amendment prohibited multibank holding companies from acquiring banks in other states unless the laws of the states in which the acquired banks were located affirmatively permitted entry. The Act continued to allow intrastate acquisitions and de novo entries without regard to state branching restrictions, although a number of states imposed their own restrictions on holding companies that were not covered by the federal legislation.

The Act was amended in 1970 to include one bank holding companies and to permit bank holding company affiliates to engage on an interstate basis in a number of bank-like activities. In a refinement of the 1956 limitations on nonbanking activities, many activities "closely related to banking" — other than deposit-taking — could still be performed on an interstate basis by bank holding company affiliates such as finance companies and mortgage banking operations. By 1976, bank holding companies and banks controlled 47 of the top 100 mortgage banking firms and 35 of the top 100 noncaptive finance companies, engaging in consumer sales and commercial finance; factoring; and "full-payout" leasing.

Economic and Demographic Developments

Our country has undergone dramatic changes since the last time Congress meaningfully addressed the question of geographic limitations as that policy was reflected in the McFadden Act and the later adoption of the Douglas Amendment. Quite clearly, changes in the society being served by the financial system were a major factor in the passage of the liberalizing branching amendments in 1927 and 1933. As stated by one member of Congress in explaining his vote in favor of the earlier expansion:

> I am persuaded to vote for this measure for the reason that crowded conditions, traffic regula-

> tions, lack of parking facilities in our cities necessitate some change in banking facilities to suit the convenience of the complex and crowded business world. Banks, bankers, and customers in large cities are in a situation similar to telephone, electric light and gas companies, or the post office, all of which have branches for the customers' convenience. Economy in time, energy, and many other factors demand that the old order give away to a modern and sensible plan. Party traditions and prejudices should not fetter or bind us to the detriment of our country or the service of our constituents. Remarks of Rep. Watkins, 66 Cong. Rec. 1775 (1925).

Since that legislation was passed, changes have occurred even more rapidly. Assuming consistency in approach, the framers of the McFadden Act themselves would today revisit the branching issue with an eye toward permitting more expansive branching activities. It seems both fair and reasonable to expect a similar treatment from the present Congress.

Just as Congress fifty years ago took note of the evolving society and its changing financial needs, CBA urges this Congress to acknowledge that the events of the past five decades have radically changed the face of the nation being served by the financial services industry. By way of comparison, in the census that followed the adoption of the National Bank Act, 74.32 percent of our population lived in rural areas. By 1930, Americans had moved to the cities so that only 44 percent of the population lived in rural areas. By 1980 there had been an almost total reversal of the action of a century earlier, with 73.7 percent living in urban areas after having passed through a phase of accelerated urbanization and suburbanization. The now well-known concept of standard metropolitan statistical areas (SMSAs) was not even officially recognized until 16 years after the question of branch banking limits was last addressed in federal legislation.

The traditional notion of staying in one place has also changed. During the period from 1975 to 1980 almost one of every two Americans moved. Of those who moved, more than half moved twice. Moreover, the giant strides in transportation systems make our society truly a nation in motion, with both business and recreation travel making today's consumer a veritable moving target.

All of these social and demographic changes have had a direct impact on the types of financial services sought by consumers and the appropriate delivery mechanisms to be used in providing them. New competitors not constrained by geographic limitations have been able to identify and meet the needs of the new consumer.

Twenty Years of Continuing Analysis and Debate

Following the passage of the Bank Holding Company Act, pressure continued on state legislatures and Congress to ease restrictions on intra- and interstate branching. In 1961 the Commission on Money and Credit recommended federal legislation to permit branching throughout metropolitan areas, even across state lines. Similar recommendations were made in 1962 by the Comptroller's Advisory Committee on Banking. The FINE Discussion Principles, released in 1975, recommended that major metropolitan areas be opened to branching by out-of-state banks.

At present, ten states have enacted interstate banking legislation, and interstate banking bills are pending in a number of states. Maine's statute has resulted in the purchase of Maine institutions by New York and Massachusetts bank holding companies.

Massachusetts has passed legislation permitting entry by bank holding companies in New England states while New York allows entry on a reciprocal basis. Delaware and South Dakota actively seek entry by out-of-state bank holding companies on a non-reciprocal basis, but for economic development and employment reasons. Finally, Washington allows entry by out-of-state bank holding companies to allow for the acquisition of troubled institutions.

The current result of the McFadden Act and the Douglas Amendment is a patchwork of state laws that in some cases require unit banking, in some cases allow branching within counties or within contiguous counties, and in some cases allow state-wide branching. In addition to thwarting the development of a national policy on the shape of the financial services industry, these laws severely limit the development of banking activities particularly at the retail or consumer level.

Effective National Policy Must Include Parity For State-Chartered Institutions

We appreciate fully that Congress has principal authority over national banks and the activities of bank holding companies. However, there are substantial ties between the federal government and many state-chartered institutions through the pervasive federal deposit insurance system. Congress has seen fit on a number of occasions to use that nexus to establish the laws and regulations governing these institutions. For example, limitations on interest rates payable on deposits have applied to banks chartered at both the state and federal levels.

In the pursuit of parity, state-chartered institutions should enjoy the same rights with respect to branching as do their counterparts chartered at the federal level. For these reasons, CBA urges Congress, as it removes the restrictions imposed by the McFadden Act, to provide a comparable authority for state-chartered institutions. The importance of a national system of financial institutions is such that authority should be absolute. If essential in order to obtain passage, however, limited rights on the part of the states to override that provision as it relates to state-chartered institutions might be a necessarily acceptable resolution.

For many years the states have been urged to reevaluate and reconsider their positions with respect to branching activity. Over a decade ago the Hunt Commission actively encouraged the states to reconfigure their branching statutes so as to more accurately reflect contemporary realities. In substantial part, that congressional plea for state action has fallen on deaf ears. Accordingly, it is time for the federal government to strike a clear policy with respect to these matters, and to develop a cohesive approach to this problem.

Recent Events Have Outpaced These Statutes, Rendering Them Obsolete

Although depository institutions have been restrained by existing geographic limitations, the industry has continued in its efforts to acknowledge the workings of the market. Pursuing efforts to serve the market, despite the presence of static regulations, banks and bank holding companies have as a practical matter increasingly avoided geographic restrictions applicable to many bank activities over the past few years. Those activities include consumer loan and leasing operations, import-export financing, certain shared electronic transfer services and general commercial lending. The barriers have been breached largely as a result of foreign bank activities and the innovative use of bank holding company rules and Edge Act corporations. In addition, geographically unrestricted, nonbank entities have increasingly been able to offer retail banking services that directly compete with those offered by banks.

As a result of the 1970 Bank Holding Company Act amendments, many bank holding companies are heavily involved in activities "closely related to banking," such as leasing, factoring and finance company activities, all conducted on an interstate basis. Another important development has been the growth and use of "loan production offices." These offices, which neither make loans nor take deposits, essentially exist to produce loan business for banks on an interstate basis. In 1980 over 350 loan production offices were operating throughout the country.

Many banks also engage in some interstate operations through the ownership of Edge Act corporations. These corporations, authorized to engage in international banking, have been permitted to branch interstate since the enactment of the International Banking Act of 1978. Though they are still limited as to the types of services in which they can engage, their use has expanded in recent years as Edge Act corporations have become established in money centers throughout the country.

The International Banking Act included an effort to rectify the competitive disadvantages faced by domestic banks vis-a-vis foreign banking organizations. Previously, foreign banks were able to branch across state lines, and foreign bank holding companies could own domestic banks in one state and operate branches or agencies of the parent bank in other states. The 1978 legislation achieved some measure of parity — although grandfathering certain aspects of the disparate treatment — but a more salutary approach would have been to extend to domestic banks the extensive powers permitted foreign operations.

However, a major inequality still exists between domestic and foreign banks. Foreign banks are not restricted in purchasing a domestic bank, whereas an out-of-state domestic bank may be precluded from acquiring a bank in a neighboring state. It has been suggested that between the effects of McFadden/Douglas and the antitrust laws, the only potential acquiror for a major domestic bank may be a foreign bank. Clearly, the solution to this inequity is not to impose on foreign banks the limitations that currently apply to domestic bank operations. In view of the vast market changes that have occurred in recent years, the only sensible resolution of this inequality is to extend to domestic depository institutions the rights that foreign banks have enjoyed and continue to enjoy.

One major source of increased competition and market pressure on banks is the increased authority granted to thrift institutions under the Garn-St Germain Act and other recent statutory changes. Thrift institutions have greatly increased power in both asset and liability areas, and are in direct competition with bank operations. Most thrifts offer NOW accounts that to depositors are the functional equivalent of demand deposit accounts. Asset powers have been expanded to allow increased commercial lending by federal savings and loans associations. State-chartered thrifts are frequently even less hampered by limitations on asset powers.

Of greater significance, thrift institutions are not restricted along geographic lines to the same extent as banks. In 1980, the Federal Home Loan Bank Board permitted full intrastate branching by federally-chartered savings and loan associations in all states, regardless of state restrictions. More recently, interstate branching of thrift institutions has been permitted in a number of cases. Credit unions for some time have operated without geographic restrictions of any sort. Although credit union members must share a common bond or affinity, the prevalence of industries operating nationwide allows many credit unions to do the same.

As we have noted earlier, nondepository institutions' competition with banks has also been increasing. The most dramatic example is the competition provided by brokerage firms for "deposits" through money market mutual funds. These funds, unfettered by geographic or other restrictions, garnered well over $200 billion in deposits by 1982. They permit third-party payments through check-like instruments, and many times combine checking account features with brokerage and other cash management services. Finance companies and retailers make consumer loans on a nationwide basis, and some may even issue deposit-like instruments. Mortgage companies, insurance companies and credit card companies also offer similar products, and operate free from geographic restrictions.

Quite clearly these market innovations are the natural response to a dramatic increase in consumer awareness and demand. CBA is in no way urging limitations of these or any other consumer financial services providers. We offer them only as examples of the emergence of a nationwide market for financial services, a market that CBA's members want to serve — and should be permitted to serve — on the basis of parity of treatment with their competitors.

Emerging technologies make geographic restrictions on bank operations even more anachronistic. With the development of electronic payment systems — including automated teller machines, automatic wire transfers, telephone transfers among accounts or institutions and home banking through computers — consumers and businesses are provided with a number of services that facilitate banking on a basis that does not yield to governmental boundaries. Businesses, and particularly large businesses, have virtually instantaneous access to credit markets nationwide. As we will note, restrictions on electronic terminal deployment in reality affect only those customers that do not have ready access to more sophisticated intermediation services — household depositors, small business and agriculture. These restrictions clearly provide no service to the public.

Most recently, interstate barriers were breached in the Garn-St Germain Act, which permits cross-industry and interstate mergers of failed or failing banks and thrifts in some cases. Though this legislation was an important step, the banking industry should not be forced to shoulder the burden of a badly managed or otherwise failing institution in order to be able to take advantage of regional and national markets.

The barriers erected by the McFadden Act and the Douglas Amendment are simply ineffective in preventing the inevitable movement toward nationwide financial services. Consumers and businesses are increasingly served by and dependent upon these services. At present, however, depository institutions are severely hampered in their efforts to take part in this expanding market. For a variety of historical reasons they have been singled out and subjected to limitations that do not apply to other providers of consumer financial services.

It should be stressed that the area in which depository institutions are most restricted is in the provision of consumer financial services to individuals. Most other functions can be performed across state lines already -- albeit in a less efficient manner -- through a variety of bank and bank holding company subsidiaries and affiliates. But the question remains: Whose interests are served by limitations that cause systematic inefficiencies? Certainly not the public's. It is time that the artificial barriers created by the McFadden Act and the Douglas Amendment be eliminated in order to allow depository institutions to geographically operate on an equal footing with all other providers of financial services.

Sound Policy Supports Permitting Geographic Parity

Many issues have been raised in connection with the expansion of depository institutions' activities, and those of their holding companies. Opponents argue that expanded branching would decrease competition, threaten the survival of small banks, strain the safety and soundness of the banking system generally and signal the end of the dual banking system. CBA believes that these developments will not occur. To the contrary, we believe that permitting the provision of financial services without regard to governmental boundaries will advance the goal of developing healthy competition in the financial services industry.

Empirical studies indicate that in the financial industry, as in other industries, services and prices respond favorably to increased competition and lower barriers to entry. Restraints on geographical expansion create artificial barriers to entry and have the effect, in many cases, of decreasing competition. It seems reasonable to assume that existing restrictions on branching and holding company activities have the practical effect of permitting or even encouraging pockets of monopolies or near-monopolies. These restrictions actually protect these anticompetitive practices.

Expanded geographic branching and ownership of banks by bank holding companies would undoubtedly result in some market adjustments, possibly including marginal increases in concentration in some areas. However, the data indicate that liberalized entry would have a positive impact on bank performance by requiring banks to respond to actual and potential competition. Thus, any conceivable anticompetitive effects of higher levels of concentration are likely to be offset by the positive competitive impact of potential new entrants whose participation is made possible by the demise of artificial barriers.

More specifically, economic studies do not support the notion that decreasing barriers to interstate financial activities would lead to an undesirable concentration of resources. In the first place, concentration in and of itself is not objectionable. It is only when that concentration becomes anticompetitive — a result against which a full panoply of antitrust rules is designed to guard — is this outcome troublesome.

Moreover, domestic depository institutions' share of national and international banking and financial services markets has been declining. As a separate segment of the depository institution industry, commercial banks also command a smaller proportion of the total financial assets that are held by all depository institutions. Thus the banking industry is not likely to experience undue concentration even if geographic restrictions are eased. In addition, should unproductive concentration in the industry become a problem in the future, it can be dealt with through the application of antitrust laws in the same way that undue concentration or predatory practices in other industries are addressed. The remote possibility of future concentration that produces an anticompetitive result simply does not present a sound basis for binding the banking industry to governmental boundaries.

Moreover, the grandfathered activities of several multi-state bank holding companies provide vivid testimony to the lack of adverse consequences that result from these arrangements. In fact, in the upper Midwest, there are two prominent holding companies whose affiliates serve the northern tier of this area. We are unaware of any reports of concentration, let alone suggestions that this arrangement has injured competition, stifled the entry of new participants or had any of the dire consequences attributed to this type of expanded geographic activity. There has been a similar experience with states that have adopted statewide branching. None of the perils that presumably have been instrumental in preventing 30 states from adopting this approach have materialized in those states that have taken this step. The concept of expanding the geographic basis on which consumer financial services are offered has proven to be both constructive and sound.

Concern has also been expressed over continued levels of service to local borrowers and depositors with the advent of expanded financial service distribution. In comparative studies, liberalized branching rules are associated with more banks per capita and more bank services available in smaller locales. There is absolutely no indication that credit availability to local borrowers and businesses declines in a liberal branching environment: To the contrary, studies indicate that bank expansion can result in more loans going to locally based customers. Current experience shows that rural and suburban branches are not used simply to gather deposits for the use of the main office. Rather, branching eases the process of distributing credit within a geographic area to the areas where it is most needed. Typically, this exchange is made among branches rather than between branches and the home office. Thus there is no indication that out-of-state branches of a money-center bank would be used simply to increase the deposit base of the home office. This undoubtedly is particularly true in the new financial environment, which has raised competition for deposits to historic levels. It also should be remembered that the Community Reinvestment Act requires depository institutions to demonstrate how a branch will meet the credit needs of its local community. For this reason, too, local credit seekers will not be harmed by increased interstate banking activity. In fact, the heightened competitive environment is likely to produce benefits to local borrowers by offering them a wider range of credit and deposit services with rates reflecting that competition.

There is some fear that increased geographic expansion would signal the end of the small bank that provides services to a local community. Despite these concerns, the evidence simply does not support this conclusion. In a number of areas in which branching laws are unrestrictive, small banks have not only survived but prospered. Small banks enjoy a number of advantages, in terms of established customer relationships and loyalty, convenient location and knowledge of the local market, which simply cannot be matched by interstate bank operations. Studies show that economies of scale are limited to a significant extent in the banking industry. Thus, large-scale operations are not likely to produce cost reductions that would threaten smaller operations.

Current experience bears this out as well. Unit banks in California continue to be strong despite competitive pressures from intrastate networks. In New York, upstate banks have successfully competed with and even inhibited the expansion of the money center banks based in New York City.

It is altogether possible that some depository institutions would not prosper as a result of liberalization of branching restrictions. However, to the extent that these entities are unable to compete and maintain their customer bases in the face of increased competition, their continued operation demonstrates market inefficiency. Furthermore, the market changes likely to result from reduced geographic restrictions on banking are inevitable in any case. Those same small institutions that might not survive expanded geographic opportunities will surely also not survive the increased competition they face from the expanded activities of the growing number of nondepository financial services providers. To maintain restrictions simply in an attempt to protect these inefficient institutions is to ignore the reality of the marketplace.

With respect to safety and soundness considerations, decreasing branching restrictions would produce far more benefits than drawbacks. Geographic diversification should reduce risks to individual institutions. Although the evidence is not complete on this point, it appears that branching is associated with greater stability of deposits and, therefore of the banks themselves. In any event, decreased restrictions on geographic expansion should result in weaker institutions being more easily absorbed by existing banks. Moreover, the antitrust implications of these mergers should be reduced by the presence of an increased number of competitors that will confront the acquiree.

Finally, critics of geographic expansion fear that lowering the barriers will be detrimental to the dual banking system. However, it should be remembered that we are discussing two quite separate barriers to geographic expansion -- one, the McFadden Act, relating to national bank branching, and the other, the Douglas Amendment, relating to the ability of bank holding companies to own banks in more than one state.

Clearly, revision of the Douglas Amendment should have no appreciable effect on the dual banking system. That system in essence provides an alternative means of entry into the banking business, with alternative sources of regulation and supervision. To remove the restrictions on interstate ownership of banks would in no way threaten this basic structure. If only the Douglas Amendment restrictions were removed, banks owned by an out-of-state bank holding company would be subject to the same branching restrictions that affect them now. State-chartered banks owned by these out-of-state companies would continue to be regulated by state regulators. An example of this is provided by looking at the experience of First Interstate. This is an interstate bank holding company that was grandfathered in 1956. The holding company owns both state-chartered and national banks and, in fact, its lead bank is state-chartered. The prominence of this multibank, multistate holding company with both national banks and state-chartered banks demonstrates the viability of the dual banking system, even in light of multistate holding company activities. In short, the dual banking system would remain unchanged by this revision.

Amendment of the McFadden Act to permit interstate branching by national banks could put pressure on state legislators to ease restrictions on state bank branching. This, however, should not be considered to be a significant barrier to federal action. The history of the branching issue is a history of a constant game of catch-up between the states and the federal government. If, as a matter of public policy, Congress concludes that interstate branching is important and beneficial to the public at large, as we believe it is, the fact that McFadden Act amendments could act as a spur to state legislators to take similar action should serve as an incentive to action.

The financial markets have changed considerably since the 1920s when the branching issue was first directly addressed at the federal level. To continue the outdated restrictions imposed by federal law on the development of interstate banking systems would have no appreciable effect on the market deregulation being brought about by other financial services providers. Its only effect would be to continue and exacerbate the position of competitive inequality now faced by depository institutions. Moreover, as interstate activities by nonregulated services providers increase, the position of the depository institutions industry will become one of greater and greater inequality. This issue of restoring a basic level of parity must be addressed by Congress as a matter of the highest priority.

EXPANDED ELECTRONIC FUND TRANSFER CAPABILITIES

The issue of interstate deployment of electronic fund transfer services is a subpart of the issue of geographic restrictions on financial activities in general. Restrictions on interstate branching became restrictions on interstate deployment of automated teller machines when the courts equated those devices with branches. This is a particular problem with respect to national banks, whose automated teller machine (ATM) deployment has been severely hampered by these determinations.

ATMs are simply one of a number of different services that can be offered using electronic fund transfer technology. Other services include point-of-sale (POS) terminals, telephone transfer services, and the like. Though a number of these services may be offered by depository institutions on an equal basis with nondepository providers of consumer financial services, both federally and state-chartered banks face a number of unique restrictions on the deployment of ATMs, the most important of these services.

For national banks, these restrictions stem from limitations on interstate branching imposed by the McFadden Act. That Act limits national bank branching to the branching rules of the state in which the national bank is located. Though this would not appear to put national banks in a position that is any worse than that of state-chartered banks, in fact the national banks' position is significantly different when it comes to ATMs. This is the result of restrictive judicial interpretations placed on the McFadden Act's definitions of a "branch."

The Act defines "branch" to include any office, agency or place of business "at which deposits are received, or checks paid, or money lent." In a 1976 case, the Court of Appeals for the District of Columbia Circuit ruled that an ATM met the Act's definition of a branch, and invalidated on OCC regulation providing that ATMs were not branches and could be established using rules other than those set for branches. *IBAA v. Smith*, 534 F.2d 921 (D.C. Cir.) *cert*. *den*. 429 U.S. 862 (1976). A number of other federal Courts of Appeals have followed that decision.(2) As a result, in any given state, national banks may deploy ATMs only where a state-chartered bank in that state may operate *branches*. The inequity results from the fact that many states define branches in such a way as to exclude ATMs. Therefore, in many cases, state-chartered institutions are permitted to establish ATMs

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2. *Lignoul v. Continental Illinois*, 536 F.2d 176 (7th Cir.), *cert*. *den*. 429 U.S. 862 (1976); *Kostman v. First National Bank*, 538 F.2d 219 (8th Cir.), *cert*. *den*. 429 U.S. 941 (1976); *State Bankng Board v. First National Bank of Fort Collins*, 540 F.2d 497 (10th cir. 1976), *cert*. *den*. 429 U.S. 1091 (1977).

irrespective of state limits on branching,(3) while national banks are subject to those limits with respect to branches and ATMs alike.

In addition, when applying to establish an ATM, a national bank must make a showing to the Comptroller's Office similar to (though not as extensive as) the showing needed to establish a full service branch. For example, the Comptroller may deny the application to establish an ATM if the bank's Community Reinvestment Act record is unsatisfactory.

State-chartered banks, too, are subject to a variety of state laws concerning ATM deployment. Some states allow liberal deployment of these terminals, while others require substantial procedural and substantive tests to be met before a terminal may be established.

These restrictions continue despite the freedom that characterizes ATM deployment by nondepository institutions. Nonbank institutions that have recently announced plans to deploy electronic terminals include grocery stores, gas stations and travel card companies. These entities can place their terminals anywhere they want, unrestricted by state or federal banking laws.

The difficulties faced in this area by commercial banks are made even less palatable by the fact that there is a severe lack of parity among federally insured depository institutions. The restrictions imposed on banks do not apply to federally chartered savings and loan associations, which are permitted to establish electronic terminals irrespective of state boundaries. Under existing regulations of the Federal Home Loan Bank Board, federal savings and loans may deploy ATMs any place in the country. For example, Washington, D.C.-based

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3. At least 17 states provide either by statute or regulation that ATMs are not branches. These states include Connecticut, Florida, Maryland, Michigan, Nortn Dakota, Rhode Island, Kansas and Washington.

Perpetual American Federal Savings & Loan could put a full-service ATM at National Airport — or, for that matter, at O'Hare Airport in Chicago — while Washington, D.C.-based Riggs National Bank could not.

The recent expansion of electronic networks also makes restrictions on proprietary ATM deployment not only unpalatable, but also absurd. No discernable public policy is served by allowing banks to share ATM facilities, but forbidding them to deploy their own.

This lack of essential parity, among both federally insured financial institutions and all other providers of consumer financial services, is a matter of utmost concern to the CBA. Although we favor the eventual removal of all restrictions on interstate banking, we are seeking as a first stage in this process the removal of all limitations on interstate EFT services. We believe that this step, though limited, is both achievable and exceedingly important as a critical step in devising a more competitive and convenient financial services industry.

This suggestion involves two separate legislative components. The first is an amendment to the National Bank Act to specifically permit ATM deployment by national banks on a nationwide basis. The second is independent legislation that would permit any federally insured depository institution to deploy ATMs nationwide. Though the latter step would obviously affect state laws, we would reluctantly agree to a provision permitting states the option of a time-limited override of the federal preemption as it relates to state-chartered institutions as has been done in a number of cases in recent years, if such a provision were necessary to obtain passage.

Technological advances create a constant problem for depository institutions that must operate in an environment hampered by static laws and virtually static regulations. Even regulatory attempts at change that recognize the possibilities presented by changing technologies are often ineffective, as was the case with the Comptroller's 1974 regulation. The 1977 Final Report of the National Commisssion of Electronic Fund Transfers argued that EFT services should be subject to different and less restrictive geographic expansion standards than those applicable to branching in general. Now, six years later, it is time to implement that recommendation in light of the significant market changes that have developed. Full interstate deployment of all EFT services should be available to all depository institutions.

A Proposal For Creating Geographic Parity

The CBA strongly believes that the only viable solution to the problems created by current geographic restrictions on providing consumer financial services is to repeal those restrictions. We recognize that this solution is far more easily enunciated than accomplished.

Acknowledging the difficulty inherent in moving directly to that result, CBA would reluctantly suggest the consideration of a phased elimination of geographic restrictions. This approach would be similar to that used in 1980 for phasing out deposit interest rate ceilings. It would enable the financial services industry, state legislators, and state and federal regulators to anticipate and address the issues that would inevitably result from this change.

As noted earlier, we would suggest that the first step be the elimination of all restrictions on the deployment of electronic terminals. In large measure, this would merely provide parity to commercial banks, since federal savings and loan associations and other financial services providers currently have that capability.

A second phase would involve expanding branching authority and enabling bank holding companies to acquire or initiate banks on a national basis. This amendment would permit regional branching (without regard to state laws or lines) and, as is now permitted for bank holding company expansion, branching based on agreement between or among individual states that permit out-of-state institutions to branch in the host state. The first of these steps would involve nothing more than the recognition of the demographic changes that have occurred since Congress last addressed the branching issue. Activity that occurred at a city or town level five decades ago is more likely now to occur commonly throughout a greater metropolitan area. The bank holding company aspect would involve permitting either the acquisition of existing banks or starting a bank de novo. Acquiring existing banks would protect the investment in the aquired banks. De novo entry would permit a slower, more deliberative evolution, yet still enable expanded competition.

The third and final phase would be the repeal of the Douglas Amendment and those portions of the McFadden Act that restrict branching activities. This final step, timed to enable the various participants in the financial system to react to it, would simply be a recognition of the lack of restrictions on nondepository financial competitors.

At each of these steps, careful consideration should be given to ensuring parity between federally and state-chartered institutions. We would urge that state-chartered institutions be allowed to undertake activities permitted to comparable institutions chartered at the federal level. Not only is such parity consistent with CBA's general approach to the new financial order, but it also builds upon a series of relevant precedents. For example, in Part C of Title V of the Depository Institutions Deregulation and Monetary Control Act of 1980, Congress permitted state-chartered institutions to have the same alternative interest rate ceilings as had been permitted to their federally chartered counterparts many years before. Additionally, in the Garn-St Germain Act of 1982, the same parity was given state-chartered institutions with respect to alternative mortgage programs.

We believe that this structure for a systematic removal of archaic restrictions provides the only achievable method of bringing depository institutions into line with their new competitors. CBA urges prompt action on this vital issue.

DEREGULATION OF BANK PRODUCTS AND SERVICES

As the members of this Committee are aware, depository institutions have long been subject to quite narrow restrictions on the types of business activities in which they may engage. Though other financial service providers have successfully penetrated traditional "banking" markets by such means as money market funds and cash management accounts, depository institutions have been prevented, principally by the Glass-Steagall Act, from engaging in most types of securities activities, and precluded by the Bank Holding Company Act from undertaking any activities other than those narrowly defined as "closely related to banking." This section of our testimony will address the Treasury Department's proposal for deregulation of "non-banking" activities, including securities activities and other financial services such as real estate and insurance.

Proposals for Deregulation

Several legislative proposals have attempted to address the issues of depository institution deregulation. Though the Garn-St Germain Act accomplished much in eliminating many distinctions among depository institutions, it only started the process of furthering competition with non-depository entities by authorizing a money market deposit account.

As originally proposed by Chairman Garn, S.1720 did contain a title that would have permitted banks and thrifts to directly engage in certain limited securities activities; namely, the underwriting of municipal revenue bonds and the sponsorship and operation of all types of investment companies. This title was deleted from the bill that eventually became the Garn-St Germain Act. As will be discussed more fully, this proposal, in our view, had significant merit, especially in its approach of permitting banks to directly engage in the new activities. However, it was too limited in terms of substantive deregulation of depository institution activities.

Another proposal, introduced as S.2490 in the 97th Congress, was presented by the Treasury Department. This proposal represented a significant advance toward true deregulation by authorizing bank holding companies to generally engage in "activities of a financial nature" and, specifically, investment, brokerage and development in real estate and insurance underwriting and brokerage.

Though we have certain reservations regarding the wisdom of the structural scheme contained in the Treasury proposal and believe an even broader range of activities should be allowed, CBA does support the Treasury proposal as a workable approach toward deregulation in today's environment.

Expansion of Bank Products and Services

Securities Activities

Regardless of the structure imposed on the offering of securities products and services by depository institutions, which will be discussed later, CBA believes that it is important to expand the list of permitted securities activities for depository institutions. In this context we would like to discuss briefly, as a predicate, the history and basis of the Glass-Steagall restrictions on bank involvement in securities activities, and then discuss more fully the kinds of securities activities in which we believe depository institutions should be permitted to engage.

Glass-Steagall Act. The Glass-Steagall Act was enacted in 1933 in response to very specific circumstances. Then, in the depths of the Great Depression, it was generally believed that among the causes of the many bank failures was the significant involvement of commercial banks in investment banking through securities affiliates. The purpose of the Glass-Steagall Act was to protect against the hazards that were attributed to the then largely "unregulated" combination of commercial and investment banking. However, the Glass-Steagall Act never established an absolute wall between securities and banking activities, for it did permit banks to engage in various securities activities, such as underwriting general obligation bonds and purchasing and selling securities for the account of bank customers.

Conditions have changed dramatically during the fifty years since the Glass-Steagall Act was enacted. Technological, economic and market changes have, in effect, turned the Glass-Steagall Act into an anachronism and a barrier to economic growth. The growing involvement by securities firms in what traditionally has been perceived as banking activities demonstrates the natural affinity of these activities. But the complementary natural growth of the depository institutions industry is thwarted by outmoded legislation, the Glass-Steagall Act. A legislatively imposed artificial wall between securities and banking activities is no longer tenable nor desirable in today's business environment.

CBA as a general matter supports the principle that depository institutions should be entitled to engage in securities activities. We wish to discuss several specific securities activities that have been proposed or should be authorized for depository institutions.

Municipal Revenue Bonds. CBA believes that the easiest task before this Committee and the Congress is to allow depository institutions to engage in the underwriting of municipal revenue bonds, including industrial development bonds. This proposal has been before Congress many times and has, in fact, been passed by the Senate. It was deleted from the Garn-St Germain Act just before mark-up in this Committee.

Since 1933, banks have been permitted to engage in the underwriting of general obligation bonds. Municipal revenue bonds were an insignificant part of the municipal bond market in 1933, but they have grown to be the largest single segment of that market today.

It makes little sense today to prohibit depository institutions from underwriting revenue bonds. The original proposal in S.1720 was strongly supported by depository institutions and state and local governments. CBA urges the Committee to eliminate the historical impediment that prevents depository institutions from offering this service to local governments and investors.

It is CBA's position that there is very little difference between industrial development bonds and municipal revenue bonds, and that depository institutions should be permitted to underwrite both types of obligations. There is little increase in risk to the depository institution between underwriting industrial development bonds that are truly for a "public purpose" and underwriting traditional municipal revenue bonds. It should be noted that tax legislation last year placed significant limitations on the issuance of non-public purpose industrial development bonds, which make these types of securities no longer economically advantageous.

Investment Companies. Depository institutions should be allowed to sponsor, operate and underwrite and distribute the shares of all types of investment companies. We believe that this issue has been fully aired before this Committee on numerous occasions, and that enactment of such authority is long overdue. The pressures on banks to offer services competitive to mutual funds have lessened somewhat with the passage of the Garn-St Germain Act authorizing the money market deposit account. Banks, however, are still eager to be able to offer the full panoply of mutual fund services, such as tax exempt and corporate bond funds, which other financial service providers can offer to their customers. The ability to offer such funds is a natural complement to the provision of retail deposit and banking services to bank customers.

Since investment companies are separate legal entities regulated by the Securities and Exchange Commission whose shares must be registered under the Securities Act of 1933, permitting depository institutions to organize and manage these funds poses little additional risk to the institution or the public. Various existing securities law provisions, especially those in the Investment Company Act restricting affiliate transactions, as well as relevant banking law regulations, would be effective in preventing the types of subtle hazards contemplated by Glass-Steagall.

In view of this, depository institutions' authority to sponsor investment companies should not be limited to the so-called "money market accounts," as some opponents of the Treasury have suggested. Rather, each depository institution should be permitted to determine what kind of funds would best meet its customers' needs. For instance, in marketing IRAs, a depository institution's customers would best be served by being able to choose among a variety of investment vehicles available through that institution. Allowing depository institutions to sponsor such funds can only result in public benefit by increasing the number and nature of such funds available to the investing public and placing depository institutions on a more equal footing with other financial service providers.

Investment Advisory Services. Depository institutions have long provided investment advisory services to their customers, particularly through bank trust departments. In addition, the provision of such advisory services is an activity that is "closely related to banking" and authorized for bank holding companies and their subsidiaries. Banks presently provide discretionary management services, act as managing agents for their customers, manage collective investment funds and advise investment companies. In order to prevent litigation and its attendant delays and uncertainties, Congress should clarify existing law to explicitly authorize the offering of all types of personal and impersonal advisory services by depository institutions. This clarification is needed to ensure that the services offered by depository institutions will be fully competitive with the services now being offered by other financial service providers. The absence of any substantial abuses in the present system of offering advisory services by banks is evidence that the well-constructed "Chinese Wall" between trust and commercial activities has been effective, and will continue to be so, in avoiding potential Glass-Steagall hazards in this area.

Securities Brokerage. As the members of the Committee are aware, numerous depository institutions have in the last two years begun offering so-called discount securities brokerage services to their customers. Although the manner in which depository institutions offer these services varies, in many instances it is being done on a "joint venture" basis with securities firms. Though provision of these services is clearly permitted under present law, as both the Comptroller of the Currency and the Federal Reserve Board have concluded, it should be noted that litigation currently is being pursued by other financial service providers to restrain depository institutions from offering these services. To remove any lingering uncertainties, CBA suggests that Congress make explicit its authorization of the offering of securities brokerage services by depository institutions.

The depository institutions that have become involved in the securities brokerage business voluntarily have restricted their activities to discount brokerage services in which they do not offer any investment advice, including making buy or sell recommendations to customers. We believe that as a matter of law, depository institutions are not restricted to such limited brokerage activities, and that they could in fact engage in "full line" brokerage without violating the present strictures of the Glass-Steagall Act. We recognize, however, that in the present competitive environment litigation will likely ensue if depository institutions proceed in this area without further congressional action. Thus, we also would urge Congress to confirm the authority of depository institutions to engage in full-service brokerage activities.

Other Retail Products

The Treasury proposal would authorize bank holding companies to engage in "activities of a financial nature" and, specifically, to engage in insurance underwriting and brokerage, and real estate development, brokerage and investment.

CBA fully supports the Treasury's goals in authorizing these activities as "securing for the public the benefits of increased competition between bank holding companies and other firms engaged in activities of a financial nature." Free and open competition between depository institutions and other providers of financial services is of ultimate benefit to the general public. It is because the Treasury proposal includes authorization for such additional activities that CBA supports, in concept, the proposal even though we have reservations about the burdensome structural limitations it imposes on depository institutions.

Insurance Activities

As noted above, the Garn-St Germain Act actually restricted activities of depository institutions in the insurance area rather than expanding them as was proposed by the Reagan administration. As is discussed elsewhere in our testimony, we believe that it is essential that the insurance restrictions imposed by Title VI of the Garn-St Germain Act be removed as soon as possible.

Banks presently engage in various insurance activities, such as offering credit life and disability insurance, and banks and bank holding companies have always been permitted to engage in a general insurance business in small communities. Banks, of course, have also developed considerable expertise in managing their own insurance needs.

Bank customers often request insurance services when they are available, as in the field of credit life and disability insurance. As retail bankers, our members are interested in offering such services as property and casualty insurance and life insurance to their retail customers. These kinds of services are a logical component of a comprehensive financial services program. We have included an in-depth discussion of the insurance issue in this testimony.

Real Estate Brokerage

CBA strongly believes that its members should be allowed to participate in the real estate brokerage business. Real estate brokerage is a natural adjunct of the retail banking services already provided by our members, particularly mortgage and home improvement loans. In many instances banks presently engage in real estate brokerage-related activities, for instance in work-out situations and as an accommodation for existing customers. Banks have developed substantial expertise in evaluating and appraising real estate, and have extensive knowledge of all types of real estate markets. These present activities have caused no adverse impact on the "safety and soundness" of banking institutions, and bank customers would be well-served in a one-stop "financial supermarket" where real estate brokerage services could be offered along with other financial services.

Many non-depository financial institutions presently engage in these activities, and at least one financial services conglomerate includes an active depository institution and real estate brokerage components. In order to achieve full and free competition, banks must also be permitted to engage in these activities.

Other Activities of a Financial Nature

CBA believes that the authority to engage in general financial activities is one of the most important deregulatory provisions of the Treasury proposal. It is impossible to predict with any degree of certainty what types of financial services and products will be offered in the future to meet the demands of an evolving economy. Accordingly, flexibility should be built into any legislation so that depository institutions are able to meet changing competition and develop and offer new and innovative products to serve their retail customers. To this end, the Treasury bill directs the Federal Reserve Board to authorize new activities in order to "promote the expansion of ... competition." This directive should be stated as strongly as possible so that the regulatory scheme will be flexible enough to enable depository institutions to meet in a timely fashion the ongoing challenges they will face in a deregulated environment.

CBA supports the Treasury proposal to revise the current application procedures required under Section 4(c)(8) of the Bank Holding Company Act and allow a 60-day notice (or shorter) procedure for all "activities of a financial nature." However, it makes little sense to require three different Federal Reserve Board procedures for different "non-banking" activities, as is the effect of the Treasury proposal. As presently drafted, the Treasury proposal apparently requires no notice or approval procedure for insurance and real estate activities, but does require a 60-day notice procedure for other "activities of a financial nature" and a full approval process for other activities "closely related to banking." CBA urges the Committee to consider streamlining the procedures for all non-banking activities.

Structure For Delivery of New Bank Products and Services

The delivery of new products and services by depository institutions can be accomplished in several ways. First and most simply, the depository institution itself could directly offer the services in the same manner that banks now underwrite municipal general obligation bonds and bank trust departments provide certain investment advisory services. Second, operating subsidiaries of the depository institution could offer the services, thereby keeping the activity within the bank's indirect control but insulating the new activities from its traditional banking activities. In this regard it is noteworthy that several banks and thrifts that have recently entered the discount brokerage market have done so through operating subsidiaries. Finally, new services could be offered through the holding company or its non-bank subsidiaries. Of course, many institutions are not owned by holding companies, so that this mechanism is not available unless considerable expense and effort are expended in forming a holding company. Factoring, insurance and discount brokerage activities have all been carried on by holding company subsidiaries.

CBA maintains that the choice of corporate structure should be, as far as possible, determined by the institution itself, and not imposed by a legislative or regulatory edict. Broad flexibility in this area will promote maximum competition and will enable all depository institutions, regardless of size or present corporate structure, to enter product markets that are most appropriate for them. A legislative mandate for a complicated and expensive structure for new services will discourage, rather than encourage, new entrants into the financial services markets. In a given case, the marginal benefit of being able to offer a few new services may not justify the costs, especially if an institution also is required to transfer already existing related activities to a holding company subsidiary.

Though we recognize that the safety and soundness of depository institutions is a matter of overriding concern to the public and the regulators, we believe that safety and soundness issues can be adequately addressed by the appropriate banking regulator, regardless of what corporate structure is used by the institution.

In testimony before this Committee during the past year, various reasons have been put forward to explain why new bank activities should be conducted by separate holding company affiliates. CBA believes that, on balance, these arguments are not persuasive, and that the benefits of maximum organizational flexibility to allow ease of entry into new markets clearly outweigh any potential disadvantages.

Alleged Competitive Advantages

Supporters of the holding company approach in the Treasury proposal argue that true competitive equality between financial service providers cannot be achieved if banks are permitted to engage in such activities directly. One supposed competitive advantage of banks is their access to inexpensive funds (deposits). As interest rate ceilings are deregulated, deposits will no longer be inexpensive. All depository institutions increasingly must pay market rates for their deposits.

Arguments are also raised that in the area of revenue bond underwriting banks are unfairly advantaged because they are permitted to deduct interest expense on borrowings incurred to carry municipal bonds. This argument is irrelevant to the question of whether all new services should be offered through holding company subsidiaries. Furthermore, we submit that most securities firms do not incur any "carrying expenses" for municipal bonds since bonds in primary offerings are pre-sold to the underwriter before any payment is due to the issuer. Thus the deductibility issue is a "red herring." Moreover, the deductibility of such interest costs has recently been limited by TEFRA.

Other financial service providers enjoy competitive advantages over banks that outweigh any bank advantages, to the extent they exist. For example, such providers generally are not subject to restrictions on the lines of business in which they may engage, and have no geographic restrictions on where they may do business. In addition, they and their affiliates are not subject to the restrictions imposed on banks by Section 23A of the Federal Reserve Act. Though the Garn-St Germain Act to a certain extent rationalized and streamlined the provisions of Section 23A, it still imposes the basic limitation that banks may make only fully and specifically collateralized loans to their affiliates. Insurance, real estate and securities firms are not subject to this limitation, and this restriction may well obviate any "advantage" resulting from banks' access to deposits as a source of capital.

To the extent that banks are already engaging in some of the activities that would be expanded by the Treasury proposal, it is obvious that banks' alleged advantages have not had any real effect. For example, the supposed competitive advantages enjoyed by banks have applied for decades to the underwriting of municipal general obligation bonds. These "advantages" have not prevented securities firms from dominating the municipal securities market, where they control approximately sixty percent of the general obligation bond market.

Equal Regulation

Supporters of the Treasury proposal argue that entities engaged in the same activities should be subject to the same regulatory schemes and regulators. Although we have no general quarrel with and in fact support the principle of equal regulation, we point out that there is a distinction between regulation by the same agency and regulation under the same regulatory scheme. In many instances enforcement of the same regulatory scheme by different regulators may be perfectly sensible, and an efficient use of limited government resources. For example, the Municipal Securities Rulemaking Board issues rules covering both banks and securities dealers offering municipal securities, and the rules are enforced by different agencies, including the Securities and Exchange Commission and the federal banking agencies. Though differences in regulatory "style" may exist, we believe they are insubstantial.

The insurance activities presently carried on by banks are regulated by the appropriate state insurance authorities, and there is no reason why bank employees acting as real estate brokers should not be subject to normal state examination and licensing requirements. If situations can be identified where regulation by the same agency is essential, then direct subsidiaries of the banks could be made subject to such regulation. Equal regulation would be achieved short of requiring that all new activities be in separate non-banking subsidiaries of a holding company.

Tying

Proponents of the Treasury proposal have argued that if "non-banking" activities are permitted within the depository institution itself, "tying" of these activities to more traditional banking products will occur, resulting in higher prices and unfairly affecting competition. In response, CBA points out that tying practices found to be restraint of trade are already illegal, and that adequate means exist to enforce existing prohibitions in both the banking and antitrust laws. Moreover, there has been no demonstration that banks have attempted to engage in such "tying" practices in other areas.

Costs and Burdens of Requiring Separate Subsidiaries

Not only are the arguments supporting the requirement for separate holding company subsidiaries not especially convincing, but there are substantial reasons why separate subsidiaries should not be required. First and foremost are the costs and inefficiencies of setting up a subsidiary and, for some institutions, the need to reorganize completely into a holding company structure. Establishing a holding company can require a year or more, involves considerable expense for both legal and administrative services and adds new regulatory layers (including the Federal Reserve Board and possibly the Securities and Exchange Commission) to the bank's operations. The mandatory requirement of a separate holding company subsidiary also could result in a costly and inefficient use of human resources. Where the expertise for a certain activity already exists within the bank, it makes little sense to require the activity to be spun off into a separate entity, particularly if that expertise is also needed within the bank. CBA's position is that each depository institution should be permitted to determine for itself how best to allocate its own resources and organize its own corporate affairs. This should not be a matter inflexibly determined by statute or regulation.

A particularly troublesome aspect of the Treasury proposal is the requirement that if a depository institution adds a _single_ new securities activity to the services it offers, it must then transfer virtually all of its other securities activities to the holding company subsidiary that offers the new services. It is not clear whether other "activities of a financial nature" or insurance and real estate activities are to be similarly treated.

CBA is strongly opposed to any requirement that existing bank activities be transferred out of the depository institution. We firmly believe that such a requirement will deter a large number of depository institutions from engaging in the new activities. If activities have been successfully carried on through the bank or an operating subsidiary, there is no reason to impose a new regulatory burden by requiring the transfer of those activities out of the bank. The regulatory handicap is increased when the impact of Section 23A is factored in; when an activity already funded by the bank must be transferred to an affiliate, the bank will have the extra burden if complying with lending and collateral limitations in attempting to continue an already lawful activity. Only if certain specific activities are perceived as imposing unmanageable risks to the depository institution should a separate subsidiary requirement be imposed. This requirement should not be extended to cover services that the institution already offers.

Further Comments Concerning Structure

The Treasury proposal contains a provision prohibiting banks from publishing any advertisement that suggests that the bank shall in any way be responsible for any obligation of its affiliates. This provision is presumably in response to Glass-Steagall related arguments concerning bank entanglement in the losses or financial difficulties of an affiliate. Although we question its utility, we have no objection to the express requirement as presented in the proposal. We object, however, to any implication in this standard or elsewhere that the affiliate of the bank may not have a name that is similar to that of the bank. There may be significant economic and marketing advantages in being able to use similar or common names for different business entities in an integrated financial services organization. Other financial services providers are not subject to any similar prohibition and, in fact, often use an "umbrella" name for different affiliated companies. There is no reason why banks should be deprived of this marketing tool. Again, any safety and soundness issues raised by bank or holding company involvement in new activities is best addressed directly by the appropriate banking regulator of the depository institution.

Under the Treasury proposal, smaller institutions (those with less than $100 million in assets) may organize operating subsidiaries rather than establishing a holding company structure. Though CBA appreciates the reasoning behind this provision, we question it in two respects. First, the $100 million figure should be examined to determine if it meets the realities of today's financial marketplace, and second, the exception may create an unintended competitive imbalance among depository institutions.

Support for Treasury Proposal

In its efforts to promote true parity among competing offerors of financial services, CBA strongly supports the concept of deregulating depository institutions and their holding companies. We support giving depository institutions the widest possible flexibility in choosing their own corporate structure and in determining the services and products they wish to offer to their customers. Limiting the extent of services and the means by which these can be offered by depository institutions places such institutions at a clear competitive disadvantage vis-a-vis other providers of financial services. These limitations can only continue to work to the detriment of the public. Though the use of bank operating subsidiaries may resolve some of the regulatory issues raised by the commentors, CBA submits that such decisions should be made by the institution and its primary regulator.

CBA supports the concept of giving depository institutions further specific authority in areas such as real estate and insurance, and most vigorously supports the concept of giving them the authority to engage in activities of a financial nature as that phrase is most expansively defined. Thus, although we have certain substantive and technical reservations regarding the Treasury proposal, CBA believes that this proposal comes closest to meeting the objective of competitive parity in the provision of financial products and services.

INSURANCE POWERS

The Competitive Disparity

There is a competitive disparity between the activities of insurance companies and those of banks and thrifts. Insurance companies and agents, like banks and thrifts, realize that the traditional method of doing business, i.e., by offering a limited line of products to the same kinds of customers, is no longer viable in today's financial environment. Whole life insurance policies, with savings returns of from three to four percent, are like passbook savings accounts in banks and thrifts. There will always be a market for such accounts, but customers are more interested in less costly insurance protection and in earning a fair rate of return on their savings and investments. Insurance companies, like other providers of financial services, are broadening and changing their product offerings to meet the demands of the marketplace.

The insurance industry has responded to the needs of its customers by offering a wider range of investment and savings products. For example, insurance companies and agents are providing variable life policies with cash values dependent on the investment performance of a separate securities account, and universal life policies with savings and investment returns at money market rates. Insurance companies are also offering IRA/Keogh accounts, mutual funds, financial planning services and a growing list of deposit and loan products. Travelers Insurance is planning to offer a new money market account insured by the FDIC, and the product will be sold by independent insurance agents. In response to the changing financial services marketplace, Prudential Insurance (which already owns Bache) is planning to buy a bank in Georgia. Equitable Life offers the public a money market account with a $1,000 minimum opening deposit that is accessible by check. New England Mutual Life is entering the discount brokerage business by using its network of insurance agents to sell securities. While insurance companies and their agents continue to expand their banking products, banks and thrifts are constrained from competing in the insurance market.

In spite of the rapid expansion by insurance companies into the traditional business of banking, some segments of the insurance industry are vehemently objecting to the efforts of banks and savings institutions to offer insurance products. The only logical reason for this objection is fear of competition. However, competition in the financial services market can only result in a wider range of products for the consumer, because the providers will be given the incentive to offer innovative products and improved services at lower prices. The realities of the marketplace have blurred the outmoded distinctions between providers of financial services, making obsolete the traditional argument that insurance and banking should remain separate. In fact, the similarities between insurance and banking are already more pronounced than the differences. Both are financial intermediaries and both offer similar products. Therefore, the separation of banking and commerce argument espoused by the insurance industry should be recognized as a thin disguise to prevent competitors from entering its market.

Unlike those who are trying to impede competition, the CBA does not favor restrictions on insurance companies, their parent organizations or subsidiaries in competing for deposits, loans and other banking services. To the contrary, we welcome competition, and urge Congress to support deregulation efforts that will enable all providers of financial services to compete equally. We urge Congress to reject the anti-competitive pleas to place a moratorium on banks engaging in expanded insurance activities that will merely stifle market innovation and protect entrenched interests.

Insurance Activities of Bank Holding Companies

Title VI of the Garn - St Germain Act generally prohibits bank holding companies from underwriting insurance or from acting as an agent or broker in connection with the sale of insurance. However, Title VI is not an indication that Congress, as a policy matter, opposes bank or bank holding company insurance activities or affiliations with insurance companies. This is evident from the many activities and affiliations left intact despite Title VI.

Title VI does not affect section 92 of the National Bank Act, which expressly authorizes national banks located in communities with a population of less than 5,000 to engage in general insurance agency activites. And Title VI itself provides express exceptions to its insurance activity prohibitions. For example, Title VI permits a bank holding company to engage in insurance agency activities in locations with populations of less than 5,000, and additionally to engage in such activities in any location that a bank holding company demonstrates has inadequate insurance facilities. The exceptions in Title VI further support the view that Congress did not intend to prohibit all affiliations between banks and insurance companies or to establish a policy against all such affiliations, because Title VI permits the continuation of all insurance activities previously approved under subsection 4(c)(8) of the Act prior to May 1, 1982 and also permits all bank holding companies with assets of $50 million or less to engage _de novo_ in insurance agency activities. Moreover, Title VI in no way eliminates or restricts existing affiliations between banks and insurance companies.

A number of organizations currently control both a bank and one or more insurance companies. For instance, Beneficial Corporation, owns 11 domestic insurance companies engaged in all types of insurance activities as well as Beneficial National Bank, formerly Peoples Bank & Trust Company, of Wilmington, Delaware. Beneficial has a bank holding company under the Act. It operates under one of the subsections of section 4 of the Act, and Title VI does not affect its activities. In addition, Gulf & Western Industries, Inc. owns both The Fidelity National Bank, Concord, California, and Capital Life Insurance Co., the 32nd largest insurance company ranked by premium and annuity receipts. Household International owns Alexander Hamilton Life Insurance Company as well as Valley National Bank, 26 industrial banks and a federal savings and loan association. Avco Financial Services, Inc. owns a national bank and 13 insurance companies engaged in all lines of underwriting. Title VI does not affect any of these affiliations.

Finally, Congress enacted the Export Trading Company Act of 1982 within days of enactment of Title VI. Like Title VI, the ETC Act also amends subsection 4(c) of the Bank Holding Company Act. But, the ETC Act adds subsection 4(c)(14) authorizing bank holding companies to own export trading companies that may, among other things, underwrite and sell insurance on risks outside of the United States and, additionally, provide insurance covering the transportation of cargo from locations in the U.S. to destinations outside of the U.S.

All of the foregoing examples illustrate that it would be incorrect to view Title VI as indicative of a congressional policy against bank/insurance activites. Furthermore, the language of Title VI contains inconsistencies and lacks a substantive basis. of orderly administrative and judicial process, and is designed to preclude competition. CBA recommends that Congress repeal Title VI by expressly permitting all bank holding companies to fully compete in the market for insurance products.

State vs Federal Law

It has been argued that individual states should be prohibited from authorizing banks to engage in expanded insurance activities, and that Congress should determine what states can and cannot do with respect to financial institutions under state regulatory authority.

However, there is ample precedent for state legislative and regulatory approval of bank activities. For example, recent history with respect to NOW accounts, money market deposit accounts, interstate banking and insurance illustrates the response of state regulators and legislatures to the demands of their specific marketplaces.

It took a decade between the creation of NOW accounts and their availability nationwide. In June 1972 NOW accounts were offered by a small Massachusetts mutual savings bank to meet customer demands for checking accounts, despite the prohibition on savings institutions' ability to provide demand deposit accounts. Later that year a New Hampshire savings bank offered its customers NOW accounts. In August 1973 Congress authorized mutual savings banks, commercial banks, savings and loans and cooperative banks in Massachusetts and New Hampshire to offer NOW accounts effective January 1, 1974 (P.L. 93-100). But it was not until March 1976 that Congress authorized NOW accounts for all New England thrifts and commercial banks. Finally, in December 1980, Congress allowed all depository institutions to offer NOW accounts on a nationwide basis under P.L. 96-221 (Title III of the Depository Institutions Deregulation and Monetary Control Act of 1980.)

A dramatic example of state initiatives to deregulate can be found in the area of interstate banking. As mentioned earlier, 10 states have enacted interstate banking legislation, and interstate banking bills are pending in a number of additional states. These states have acted in the interests of the public to attract additional capital; to increase the availability of credit for consumers and businesses; to increase employment; and to attract new business. South Dakota and Delaware are dramatic examples of the benefits of interstate banking. In the first year after Delaware enacted interstate banking legislation, over $1 billion in available credit was invested in the state. South Dakota has among the lowest rates of unemployment in the country with less than five percent compared to 10.1 percent nationwide.

There is also legal precedent under the Federal Reserve Board's Regulation Y to support the proposition that individual states have the authority to authorize insurance activities by a state-chartered bank that is not a member bank of the Federal Reserve System, even if the bank is a subsidiary of a bank holding company subject to the Bank Holding Company Act.

State-chartered banks' authority to engage in insurance activities derives from the banks' express powers granted by the state legislatures. These powers do not stem from Section 4(c)(8) of the Act.

Regulation Y exempts the activities of state-chartered banks and their subsidiaries from the statutory criteria and approval process of subsection 4(c)(8) of the Act. Section 225.4(e)(2) of Regulation Y expressly authorizes a state chartered bank or a subsidiary to:

> Acquire or retain all...of the shares of a company that engages solely in activities in which the parent bank may engage, at locations at which the bank may engage in the activity, and subject to the same limitations as if the bank were engaging in the activities directly. There is no requirement that the Fed's approval be obtained.

The Fed staff has publicly stated that:

> Bank subsidiaries of bank holding companies may be permitted by their primary supervisor to engage in insurance agency activities without specific authority from the Board. The Board has taken the position that the Bank Holding Company Act does not authorize the regulation of bank-related activities of national banks and state-chartered banks even if the bank belongs to a bank holding company system. Therefore, since a bank's authorization emanates from its primary regulator, the Board concern under the Bank Holding Company Act is exclusively with the holding company and its non-banking subsidiaries. (Tie-ins Between the Granting of Credit and Sale of Insurance by Bank Holding Companies and Other Lenders; Federal Reserve Board Staff Papers, Robert A. Eisenbeis and Paul R. Schweitzer, staff, Board of Governors 19-20 (1978))

This policy is not merely theoretical. It has actually been applied by the Federal Reserve in the context of Orders of the Board issued to specific bank holding companies. In an Order dated September 4, 1973, approving an application by Piedmont Carolina Financial Services, Inc. to acquire a state-chartered bank under section 3 of the Act and to acquire certain non-bank companies engaging in permissible non-bank activities under subsection 4(c)(8) of the Act, the Fed expressly noted that the bank "engages through a wholly-owned subsidiary in general insurance agency activities at off-premise locations including one office in a community where (the) Bank does not operate any branches. It appears that (the) Bank itself could directly perform these activities at those locations." The Fed concluded that such activities expressly authorized for a state-chartered bank "do not require the approval of the Board." The Fed cited Section 225.4(e) of Regulation Y as the applicable provision for this conclusion.

This same result is found in another Order, dated June 17, 1974, involving an application by American Bancorp, Inc., to acquire a state-chartered bank under section 3 of the Act. In that Order, the Fed noted that the bank owned Berks Title Insurance Company, a title insurance subsidiary that operates offices in three states, and maintains agents in seven other states. The Board noted that the "Bank, under applicable state law, could itself directly perform these activities at such locations" and concluded that, pursuant to Section 225.4(e) of Regulation Y, "such activities do not require the approval of the Board."

Therefore, based upon the existing law, the direct and indirect activities of a subsidiary bank are not subject to either the approval process or the statutory criteria under subsection 4(c)(8) of the Act.

As mentioned earlier, CBA opposes any form of moratorium on state authorizations that would allow financial institutions to compete in the insurance industry. Until Congress takes action to equalize the treatment of all financial services companies, CBA endorses the right of states to grant expanded powers to banks and bank holding companies in order to provide competitive parity among all offerors of insurance products.

Arguments Against Expanded Insurance Powers

Opposition to bank entry into the insurance industry has focused principally upon adverse effects on the public interest, namely, decreased and unfair competition; undue concentration of economic resources; improper extension of exclusive franchise monopoly; and conflicts of interest. It has been argued that the combination of credit and insurance, the "tying" argument, would unfairly limit the consumer's ability to choose the best insurance terms and service free from the influence of credit, and would unfairly permit banks to compete against other sellers in the insurance market who have no powers to extend or withhold credit.

These contentions can best be refuted by examining the nature of the banking and insurance industries in order to determine the potential impact of the provision of insurance services by banks on competition in the insurance industry.

Commercial banks in the United States number well over 14,000. Decreasing maket concentration among commercial banks at both the local and national levels points to the absence of dominant market power in the banking industry. Yet such market dominance is an absolute prerequisite to engaging in illegal forms of tying practices. Contrary to this argument, a banking charter does not confer upon a bank sufficient market power to engage in tying. Banks still must compete with both bank and other providers of financial services for a market share of the financial services business.

Like banking, the insurance industry has highly competitive pricing, products and service. The level of competition among insurance companies is obvious to anyone who has recently shopped for coverage. Bank entry would not pose an unusual threat to these firms. The adverse effects ascribed to banks' entry into insurance, if any, would equally result from the entry of any other non-bank firms. Bank provision of insurance services will invigorate the market, bringing with it benefits to the customer that always result from competition: lower costs, lower prices and improved service.

Another major concern is the fear that banks will engage in anti-competitive tying practices in order to monopolize the insurance industry. Tying involves the use of market power in the sale of one product, the "tying product," to coerce customers to purchase some other product, the "tied product." However, the law already provides safeguards. Direct tie-ins are prohibited by Section 106 of the Bank Holding Company Act and are *per se* illegal under Section 3 of the Clayton Act and Section 1 of the Sherman Antitrust Act.

Explicit tie-in arrangements are practically non-existent. However, so-called "voluntary" tying of insurance purchases with bank loans can occur through implicit coercion of customers, which some assert will severely diminish the freedom of consumers to choose insurance coverage best suited to their needs.

There is absolutely no evidence to support allegations of voluntary tying by banks. The potential for any tying arrangement depends upon the existence of market dominance in the tying product. However, in the highly competitive industries of banking and insurance, no specific firm wields such market power. It has been demonstrated that tying arrangements rarely occur in markets where there are a large number of alternative sources of credit. Thus any attempt by a bank to coerce a customer into making a joint purchase would only result in the customer moving to another bank or credit source.

Under the rubric of decreased and unfair competition, opponents also allege cross-subsidization, predatory pricing and coercive reciprocity. Such unfair practices, however, require a strong likelihood of eliminating competitors, thus achieving monopoly profits to cover losses from severely underselling. Neither cross-subsidization nor predatory pricing is likely to occur when competitors possess comparable resources or when barriers to entry are so low that new competitors will quickly crop up. Both of these traits are present in the insurance industry. Moreover, predatory pricing is subject to challenge under the antitrust laws.

Coercive reciprocity, in which purchase of one product depends on the sale of another, also requires market dominance to be effective. This practice is prohibited by Section 106 of the Bank Holding Company Act.

The argument that bank entry into insurance will result in "undue concentration of economic resources" is the most specious of all, both as a matter of law and of public policy. This concept has no definition under the antitrust laws, and it is not clear precisely what it means.

It is not likely that undue concentration will result from bank entry into insurance precisely because the banking and insurance industries are themselves so unconcentrated. Banks face competition in almost every aspect of their business, both from other banks and non-bank financial service companies. Yet, no non-bank competitor is prohibited from selling insurance because of fears of undue concentration of economic resources. Banks should be similarly allowed to offer insurance services subject to the alternative legal mechanism of the antitrust laws, thus adding a healthy, competitive jolt to the market.

Opponents' arguments against allowing banks to engage in insurance can be reduced to a single premise, namely, that granting banks the power to offer insurance services would somehow be an improper extension of bank "monopoly" power. This assertion is clearly flawed.

As we have noted, the banking industry is unconcentrated and competitive. Banks face intense competition not only from other bank entities, but from non-bank businesses that are far less regulated than banks. Furthermore, insurance providers, while highly regulated at the state level, themselves grant credit through affiliates, much as banks do, and they are subject to the same risk of conflicts of interest.

The banking and insurance industries are thoroughly regulated, both by agencies of government and by the competitive environment that characterizes these two industries. These factors should provide more than adequate assurances for those who fear that bank entry into insurance will adversely affect the public interest. The presence of banks in the insurance industry will provide consumers with alternative sources for their insurance needs, adding to their convenience, reducing their costs or otherwise creating benefits from competitive marketing.

Conclusion

The attempts of banks and bank holding companies to offer insurance products are driven by customer demands and competitive forces. In response to the realities of the marketplace, financial institutions must be able to provide a full range of products and services so that their customers can save, invest and have access to their funds; purchase insurance; obtain loans; and receive financial advice and other services conveniently and at competitive prices. Congress and the regulators should not interfere with the ability of depository institutions to provide such products and services. In fact, Congress should act swiftly to remove regulatory restraints in order to establish competitive parity between all providers of financial services.

USURY

The volatile economic events of the past four years have made lenders more sensitive to marketplace restraints, such as state imposed rate ceilings. As long as these ceilings exist, lenders will be hesitant to extend credit as they have no assurance that today's lower interest rates will continue.

In the context of today's hearings, parity among financial institutions is affected by usury ceilings. Institutions with sufficient resources will continue to relocate certain credit operations to states such as Delaware and South Dakota that have enacted laws reflecting the demands of the marketplace. Financial institutions with more limited resources cannot afford to relocate. Those entities that operate in states with restrictive ceilings cannot price their loans to accurately reflect their costs of doing business. As a result of this disadvantage, they offer fewer products and services, and less credit. Consumers are then hurt by usury ceilings since they are unable to obtain credit.

Relocation by financial institutions affects the economies of the states with restrictive rate ceilings. Jobs and income are lost as institutions move to states that provide a more realistic financial environment. The interests of the public; the attraction of additional capital and new business; the availability of credit for consumers and businesses; and the general employment situation are adversely affected by rate ceilings. The free flow of money between the states is biased toward states without usury restrictions since they provide an economic climate that encourages production.

States' usury ceilings often differ depending on the type of loan and the type of institution that provides credit. This disparate treatment results in further inequality in the financial marketplace.

We believe that the increasing number of credit-granting institutions, coupled with the demands of the marketplace, will provide the controls necessary in the pricing of credit. Further, the recent substantial deregulation of liabilities makes the need to remove arbitrarily imposed asset limitations even more compeling.

We urge Congress to enact S.730, the proposed Credit Deregulation and Availability Act of 1983, a bill that provides a realistic response to the national problems caused by arbitrary, state-imposed usury ceilings.

CBA has testified before this Committee on the usury issue as recently as April 12, 1983. We would refer you to this testimony to further explain our position.

UNIFIED RULEMAKING

The structure through which the federal financial regulatory agencies set nationwide standards for the consumer financial services marketplace reflects a series of historical accidents. Present rulemaking by the various federal agencies creates conflicts, overlaps and gaps in the applicable standards; uneven compliance burdens for financial institutions; and a lack of uniformity in the administration of consumer protections. The trend toward fragmented regulatory responsibility frustrates the formulation of a consistent national policy for consumer financial services. CBA believes that there is an urgent need for unified rulemaking.

Prior to 1968, consumer financial services were regulated at the state level with only minor or short-lived federal intrusions. Under the 1933 Banking Act, Regulation Q gave the Federal Reserve Board (Fed) and the Federal Deposit Insurance Corporation (FDIC) authority to establish limits on the amount of interest paid on liability products. The authority was extended to the Federal Home Loan Bank Board (FHLBB) in 1966. Another example of federal intrusion was the establishment of Credit Controls (Regulation W) during World War II and the Korean Conflict. In both instances, Reg W limited the amount and terms on which consumer credit could be offered.

However, in 1968, the Congress passed the Consumer Credit Protection Act (CCPA) which contained the Federal Truth in Lending Act, and federal restrictions on garnishment. These laws were implemented by regulations issued by the Fed and the Department of Labor. Now, approximately seven federal agencies have issued regulations and rules directly affecting all aspects of consumer financial services.

Under the CCPA, the Fed has exclusive rulemaking authority for all creditors under three titles: Truth in Lending (Regulations Z - Credit, and M - Leasing); Equal Credit Opportunity (Regulation B); and Electronic Fund Transfers (Regulation E). The authority of the Fed to issue binding interpretations and regulations was upheld in Mourning v. Family Publications Service, Inc., 411 U.S. 356 (1973); the Fed staff's authority to issue interpretations which can be relied upon by creditors was upheld in Ford Motor Credit Co. v. Milhollin, 444 U.S. 555 (1980) and Anderson Bros. Ford v. Valencia, 101 S.Ct. 2266 (1981).

No agency is authorized to issue regulations under two other titles of the CCPA: Fair Credit Reporting and Fair Debt Collection Practices. However, the Federal Trade Commission (FTC) is allowed to issue interpretations of these Acts that have the effect of binding regulations. The FTC staff has issued voluminous interpretations of both Acts that have been given great deference.

Furthermore, the FTC has attempted to expand the coverage of the Truth in Lending Act by issuing consent decrees that impose requirements beyond those required under Reg Z. (U.S. Life Credit Corp. v. Federal Trade Commission, 559 F.2d 1387 (1979); in Re Shell Oil Company, FTC File No. 792 3260, 44 Fed. Reg. 63550, (November 5, 1979) and in Re Household Finance, 46 Fed. Reg. 43962, (September 2, 1981)).

The FTC, the Fed and the FHLBB all have authority to issue rules that define unfair or deceptive acts or practices. Two rules that affect consumer credit transactions have been pending at the FTC since 1975 -- the "Holder II" rule and the Credit Practices Rule. These pending rules have been the subject of tremendous controversy, and have caused great concern as to whether the costs will outweigh any resulting consumer protections. In addition, if the FTC finally promulgates these rules, both the Fed and the FHLBB are required to issue "substantially similar" rules within 60 days, unless the Fed or the FHLBB determines that the practices to be regulated are not unfair or deceptive, or unless the rule would interfere with the essential monetary policies of those agencies. Thus, FTC rulemaking would "trigger" rulemaking by other agencies. It is possible that the other agencies could issue a rule that is far different from the FTC rule and create unnecessary differences in the consumer financial services market. Furthermore, even though the FTC has no jurisdiction over banks, the existing FTC "Holder Rule" imposes compliance burdens primarily on banks, the major purchasers of credit sales bearing the FTC Holder legend. As a result, the FTC imposes certain "risk" burdens on banks which the bank regulators cannot control.

Numerous agencies issue rules that affect providers of consumer financial services. Listed below are examples of such regulations.

- The Fed issues regulations for the Home Mortgage Disclosure Act under Regulation C, which requires the disclosure of mortgage investment data by all federally insured mortgage lenders. Mortgage bankers, insurance companies and brokerage houses that offer mortgages are not covered by this regulation.
- The Department of Housing and Urban Development (HUD) issues guidelines on the Flood Disaster Protection Act, which governs loans that must be covered by flood insurance. Each financial regulatory agency issues regulations to implement this Act, further complicating the regulatory process since the coverage is not identical. For example, the FHLBB requires flood insurance coverage on credit sales of mobile home paper purchased by savings associations while the Fed, the FDIC and OCC in most regions do not. There is no logical reason for this disparity of treatment. Only federally regulated or insured lenders are covered by this regulation.
- Regulations for the Community Reinvestment Act have been issued by several agencies -- the Fed, the FDIC, FHLBB and the National Credit Union Administration (NCUA).

- Regulations for the Real Estate Settlement Procedures Act are implemented by HUD under Regulation X. This regulation unnecessarily overlaps with Regulation Z in some instances.

- Three federal agencies (OCC, FHLBB and NCUA) have each issued regulations authorizing adjustable rate mortgages (ARMs). Though all three regulations affect the mortgage market, each is significantly different. In addition, Title VIII of the recently enacted Garn-St Germain Act was designed to provide non-federally chartered housing creditors parity with federally chartered institutions with respect to alternative mortgage transactions. However, this provision has produced an anomalous result in that the FHLBB and NCUA regulations allow ARM transactions for both first and second mortgages, while the OCC regulation restricts the use of ARMs to first mortgages. The FHLBB regulation covers entities other than thrifts, such as finance companies, securities dealers and mortgage bankers, while the OCC regulation applies only to state-chartered banks. As a result of these inconsistent regulations, all entities mentioned, except national and state chartered banks, can make adjustable rate second mortgages in states that restrict or prohibit their use.

- Regulation and interpretation for state usury preemption are issued by the FHLBB for the residential mortgage and the manufactured-housing preemption provisions of Title V of the Depository Institutions Deregulation and Monetary Control Act. This applies to all creditors, even though the FHLBB supervises only savings and loans. This provision also grants to all federally insured, deposit-taking institutions "most favored lender" status that had always been enjoyed by national banks. However, the FDIC, FHLBB and NCUA issued different interpretations construing identical language. For instance, NCUA interprets the "most favored lender" doctrine as not being applicable to federally chartered credit unions. The OCC's interpretation of this doctrine is that only the provisions of a borrowed state statute that are material to the determination of the interest rate must be complied with, while the FHLBB subjects savings associations to all the provisions of a borrowed state's rate statutes.

- The disposition of income from credit life insurance premiums has been treated in a far from uniform. manner. An attempted uniform policy statement was adopted by the Fed, FDIC and OCC but was rejected by the FHLBB and NCUA.

- Under the Fair Housing Act, the OCC, FDIC and FHLBB all collect data regarding the characteristics of persons applying for residential mortgages. The reporting requirements differ. For Fed-member, state-chartered banks there is no reporting requirement under Fair Housing.

Problems in the Present System

The present federal regulatory structure with respect to the consumer financial services market creates friction between agencies, blurs jurisdictional lines and produces inconsistent, overlapping and at times contradictory rules. One problem resulting from these overlapping jurisdictional lines is the lack of familiarity with the practices of institutions affected by various regulatory bodies. For example, the FTC has no institutional experience with depository institutions. Its limited consumer credit focus had encompassed finance companies, retailers, and oil companies.

However, the FTC also regulates advertising of various products and professions, and has the power to enjoin various marketplace activities that it considers unfair. It also regulates items such as wool content of fabrics and the interstate transportation of slot machines. To have this agency issuing rules affecting the already highly regulated consumer financial service area is questionable. As a major antitrust enforcer, the FTC tends to act in a prosecutorial mode. Its tactics seem to be aimed at "fencing in" an industry through widely published enforcement actions. Therefore, we do not believe this agency is well suited to write the regulations affecting consumer financial services.

In the area of adjustable rate mortgages, each regulation establishes substantively different rules on maximum rate adjustments, maximum repayment schedules, negative amortization and disclosure. Two of these regulations (OCC and FHLBB) require disclosure at different times, in different terminology and in different levels of detail from the general credit cost disclosure rules of the Fed's Regulation Z. The OCC's and FHLBB's adjustable rate mortgage regulations affect the marketability of those instruments in the secondary mortgage market. Finally, as mentioned earlier, the FHLBB's regulation is far more liberal than that of the OCC in that it allows adjustable rate mortgages for both first and second trusts.

Recommendation

In order to provide a more balanced and consistent national policy with respect to consumer financial transactions, we recommend unified rulemaking authority within one agency for consumer financial services. Although enforcement authority would remain with each respective line agency, regulation writing by one agency would remove the problems of inconsistent interpretations. The most appropriate agency would be the Fed, based on its extensive regulation-writing experience under the CCPA. The Fed has also demonstrated its sensitivity to the various participants in the consumer financial services market by its extensive consultation with all interested parties and its excellent rulewriting of Regulations Z, E and M. This type of exclusive authority would also eliminate duplication with respect to rules proscribing unfair or deceptive acts or practices. It would replace the present FTC and FHLBB regulatory authority in that area. However, all agencies with line supervisory responsibilities would continue to function under their traditional mandates, such as ensuring the safety and soundness of depository institutions. Moreover, existing agencies with enforcement responsibilities would continue to perform those functions.

LEASING POWERS

This year marks the twentieth anniversary of the entry of national banks into the business of personal property leasing. Many banks now lease automobiles, trucks, machinery, equipment and other "big ticket" items to consumer and commercial users. Though banks have become firmly established in the leasing marketplace, the legal basis for such activities has been the subject of several court battles, and still remains unsettled. The central problem has been the absence of any explicit leasing power in the National Bank Act. As further discussed below, this absence has resulted in the courts denying the Office of the Comptroller of the Currency (OCC) the ability to determine the terms, conditions and limitations for bank leasing activities it considers appropriate. National banks need congressional clarification of their authority to transact personal property leases. Such clarification is essential to obviate what may be ongoing judicial attacks to the OCC's leasing rulings launched by banks' competitors.

Through Sec. 330 of the Garn-St Germain Depository Institutions Act of 1982, thrifts have secured an explicit statutory basis for engaging in leasing. Under Sec. 330 the FHLBB has the exclusive authority to determine the appropriate terms, conditions and limitations for such transactions. Thus, in marked contrast to the banks' situation, thrifts have an unassailable leasing authority that can be molded by the FHLBB, rather than by the courts. The potential powers afforded by Sec. 330 are far superior to those of banks in every respect.

In view of the broad nature of the thrifts' new leasing powers, the amendment to the National Bank Act we seek would be in the form of a substantively similar amendment to Sec. 330. If banks are to maintain their competitive equality with thrifts, Congress should proceed with such an amendment in the immediate future.

Development of Bank Leasing Rules

The National Bank Act does not explicitly authorize personal property leasing. As has been the case with many other bank activities, leasing has been conducted pursuant to the OCC's interpretation of what it deems to be permissible under the National Bank Act.

In 1963 the OCC issued its original leasing rules via Interpretive Ruling 7.3400 (12 C.F.R. 7.3400). These rules were based on the legal theory that leasing was part of or incidental to the business of banking, and was authorized as such under the general banking powers of the National Bank Act. That theory was rejected by the United States Court of Appeals for the Ninth Circuit in *M & M Leasing Corp. v. Seattle First National Bank*, 563 F.2d 1337 (9th Cir. 1977), *cert. denied*, 436 U.S. 956 (1978). The court held that the National Bank Act authorizes leases where "..., in the light of all relevant circumstances, the transactions constitute the loan of money secured by the properties leased." Though the court noted that a bank need not recover all of its investment plus financing costs from the lessee, a bank also could not assume "material burdens other than those of a lender of money" nor be "subject to significant risks not ordinarily incident to a secured loan." In essence, the court held that a national bank's authority to engage in leasing is not a power that is "incidental to banking" as the OCC had posited, but rather is based on and must be consistent with a bank's authority to make loans pursuant to the express lending power contained in the National Bank Act.

In June 1979 the OCC revised Interpretive Ruling 7.3400 to conform to the Ninth Circuit's mandate. 44 Federal Register 22388. Whether or not a court in the future will conclude that the OCC has correctly implemented the Ninth Circuit's mandate or will affirm the Ninth Circuit's views on what forms of leasing are permissible under the National Bank Act remains to be seen.

Advent of Leasing Powers for Thrifts

In February 1982 the FHLBB effected leasing rules for thrifts that were substantively identical to the OCC's Interpretive Ruling 7.3400. 12 C.F.R. 545.7-10a, 47 Federal Register 3541 and [illegible]. The FHLBB proceeded on the notion that because the leasing activities authorized by the OCC are designed to be the functional equivalent of lending, the FHLBB could authorize the same activities for thrifts under the consumer lending power contained in the Home Owners' Loan Act of 1933. The FHLBB leasing rules, of course, are subject to the same legal uncertainties as are the OCC's rules.

Sec. 330 of the Garn-St Germain Act has provided thrifts with an unassailable, independent and more expansive leasing authority. That provision permits thrifts to make:

> Investments in tangible personal property, including, without limitation, vehicles, manufactured homes, machinery, equipment, or furniture, for rental or sale, but such investment may not exceed 10 per centum of the assets of the association.

On April 26, 1983 the FHLBB issued its regulations implementing the many provisions of the Garn-St Germain Act applicable to thrifts. In connection with the new general leasing authority, the FHLBB's regulations would permit virtually any type of personal property leasing conceivably desirable to thrifts. The FHLBB indicated in the supplementary information accompanying the regulation that:

> Section 330 of the DIA authorizes Federal associations to invest up to ten percent of assets in all types of tangible personal property for the purpose of leasing such property. This authority differs from the authority to enter into finance leases that are the functional equivalent of loans (discussed above). Under the authority granted by Section 330, associations would not be limited to entering into net, full-payout leases, but would be permitted to assume responsibility for, among other things, servicing and maintaining the property. In addition, an association would not have to expect to be reimbursed for its investment in the leased property within the lease term....
>
> The final rule authorizes Federal associations to invest in tangible personal property for the purpose of leasing such property, provided that the residual value of the leased property does not exceed 70 percent of its acquisition cost.

Disparity Between Banks' and Thrifts' Leasing Powers

The disparity between the leasing powers of banks and thrifts as a consequence of Sec. 330 of the Garn-St Germain Act is manifest. This disparity produces two distinctly adverse effects on banks. First, where banks and thrifts offer similar leasing products, the thrifts may realize a pricing advantage. For example, in the context of closed-end vehicle leases (which are rapidly becoming the predominant lease form for other than fleet transactions because of their associated tax benefits), banks in many instances are required to obtain insurance on the vehicle's residual value. The insurance premium is a cost of doing business imposed by the OCC's requirements that necessarily is a component of the lease product's price. Second, the FHLBB now has the ongoing ability to promptly respond to marketplace developments and authorize new lease structures as it deems appropriate. The OCC, however, is bridled with a more restrictive framework within which it must operate. In a rapidly changing financial services environment, this could leave banks in a significantly inferior position.

The Consumer Bankers Association therefore urges Congress to enact an amendment to the National Bank Act creating an explicit leasing power, the parameters of which would be fashioned by the OCC on the basis of what the OCC considers to be the business of banking as that concept continues to evolve. Without such an amendment, banks will eventually be at a severe competitive disadvantage with thrifts, finance companies and other entities in the leasing marketplace.

SIMPLIFICATION AND REFORM OF THE CONSUMER LEASING ACT

The Consumer Bankers Association requests Congress to consider legislation to simplify and reform the Consumer Leasing Act. The

Consumer Leasing Act (CLA) is a law requiring certain disclosures and substantive protections to be given to consumers who enter vehicle, furniture and other personal property leases with terms of more than four months. The Association and, we believe, most other interested parties are of the view that the CLA has largely performed the role intended for it by Congress. However, the law was formulated in 1975 and 1976 and reflects many of the flawed concepts and principles of the original Truth in Lending Act before those flaws were apparent. Although the lessor community has not as yet experienced an avalanche of nuisance litigation, the CLA in its present form certainly has the potential for such an avalanche.

In order to avoid the unintended costs associated with nuisance litigation and in order to improve the law so that it fulfills its original objectives, we recommend amendments to three areas of the CLA. First, the Act's disclosure requirements should be abbreviated and simplified. It is our opinion, based on observation, that several of the current disclosures are of tertiary importance to the consumer and do not materially affect his or her decision to lease. At the same time, these disclosures are fairly complicated from the lessor's perspective, and unnecessarily attract challenges as to their propriety. Consistent with the "information overload" problem previously considered by Congress in connection with the Truth in Lending Simplification and Reform Act, we believe that it would be appropriate to pare and streamline existing disclosure requirements.

Second, there is a major imperfection in the otherwise sound scheme that conditionally limits a consumer's end-of-term liability to three monthly payments under an open-end lease, the so-called "Three

Payment Rule." The scheme presently provides that where the lessor in a lawsuit seeks more than three payments from the consumer upon lease expiration, the lessor must rebut a presumption that the lessor failed to set a reasonable end-of-term value for the leased property. Though we have no quarrel with the Three Payment Rule and its rebuttable presumption mechanism as a general proposition, we disagree with that facet of the mechanism providing that the lessor must pay the consumer's attorneys' fees where the lessor successfully rebuts the presumption and prevails in the lawsuit. This is a remarkable provision that has no precedent in any state or federal statute, or anywhere in Anglo-American jurisprudence. The attorneys' fees rule serves no apparent purpose insofar as it penalizes lessors who have proven in court that their residual value estimate was reasonable and made in good faith. Moreover, because it clearly encourages litigation, especially appeals to a trial court's decision, it represents a singularly poor social policy. Accordingly, we recommend that the law be changed so that the lessor's payment of the consumer's attorneys' fees is confined to situations where the lessor fails to rebut the statutory presumption.

Third, the current civil liability structure is in need of reform. One glaring problem is that it imposes liability for violations of all transactional disclosure requirements, including those of a hypertechnical nature or of less than primary importance to the consumer. As we have learned from approximately 13,000 federal court cases under the original Truth in Lending Act, this type of structure invites expensive litigation of doubtful social value. The same considerations that were applied by Congress in 1980 to the overhaul of the Truth in Lending Act's civil liability provisions are equally applicable to the CLA. Consequently, we recommend a revised approach, where civil liability is imposed only for those disclosure violations of central importance to the consumer. Disclosure violations of lesser moment, such as the lessor's misstatement of an amount of a late charge, ought not result in a punitive damages award to the consumer.

Another problem with the civil liability scheme is its statute of limitations. Under the current law a consumer may initiate an action at any time up to one year from the date the lease is terminated. In the case of a four year lease, for instance, the consumer can sue for disclosure violations through the fifth anniversary of the date the lease is consummated. In contrast, the statute of limitations for disclosure violations under the Truth in Lending Act has always been one year from the date of violation. The length of the CLA's limitations rule as it relates to disclosure violations has no parallel under federal consumer protection law. There is no identifiable, rational basis for this rule. The Association therefore asks the Committee to change the limitations rule so that actions must be brought within one year from the date of violation, except in the case of an alleged Three Payment Rule violation, where the consumer should continue to have one year from the date of scheduled expiration of the lease to initiate an action.

On April 18, 1983 the Federal Reserve Board forwarded to the Chairman and several other members of the Committee a proposal to simplify the CLA. The proposal represents a thoughtful review of the successes and failures of the current law, and suggests changes that are generally compatible with the simplification and reform philosophies held by the Association. As it relates to vehicle leasing, the proposal would effect many of the changes we seek. However, we disagree with some of the proposed disclosures, especially the total-lease-cost disclosure. That disclosure, though seemingly desirable, is conceptually defective because it would be based on important assumptions that would remain hidden to the consumer. Consequently, we believe that the disclosure could prove to be not only misleading, but also an unintended means by which true lease costs could be misrepresented by unscrupulous lessors. We also note that the Board's proposal does not limit civil liability to key disclosure violations, a limitation we find to be essential if nuisance litigation is to be discouraged. If requested by the Committee, the Association would be pleased to provide a more detailed set of comments regarding the Board's proposal.

EARNINGS ON RESERVES

Reserve requirements were established to permit the Federal Reserve System (FRS) to effectively monitor and control monetary policy. Title I of the Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMA) established mandatory, noninterest-bearing reserve requirements on transaction accounts and nonpersonal time deposits for all depository institutions. Prior to this Act, only members of the FRS were subject to reserve requirements. As a result, the Act provides for a gradual transition to the new requirements. Notwithstanding these phase-in requirements, a twelve percent (12%) reserve is generally required for a transaction account and a three percent (3%) reserve required for nonpersonal time deposits. As long as these noninterest-bearing reserve requirements are mandated, depository institutions cannot offer accounts that are fully competitive with those offered by the money market mutual funds (MMMFs).

The Money Market Deposit Account (MMDA) and the Super-NOW Account were authorized by the Depository Institutions Deregulation Committee (DIDC) in response to congressional concern that depository institutions be permitted to offer accounts that would enable them to compete with MMMFs. To further comply with the congressional interest of parity in this area, we understand that the DIDC will consider an unlimited transaction business account at its June 28, 1983 meeting. This potential new account, as well as the Super-NOW Account, are subject to the twelve percent, mandatory, noninterest-bearing reserve requirement. In addition, the nonpersonal MMDAs are subject to the three percent reserve requirement.

The rate penalties or "new differentials" caused by the reserve requirements are shown in the tables below:

Table 1

Cost of Funds	Rate Penalty Imposed On Depository Institutions By a 12% Reserve Requirement
6%	81 basis points
7%	95 " "
8%	109 " "
9%	122 " "
10%	136 " "
11%	150 " "
12%	163 " "
13%	177 " "
14%	190 " "
15%	204 " "

Table 2

Cost of Funds	Rate Penalty Imposed By a 3% Reserve Requirement
6%	18 basis points
7%	21 " "
8%	24 " "
9%	27 " "
10%	30 " "
11%	33 " "
12%	37 " "
13%	40 " "
14%	43 " "
15%	46 " "

The rate penalty problem could be cured by eliminating the reserve requirement on these accounts, but that would impair the FRS's ability to effectuate monetary policy. Reserves could be imposed on the MMMFs, but these would be the equivalent of a new tax on holders of these investments. This possibility was considered and discarded by Congress. However, the problem is not holding reserves, but holding sterile, noninterest-bearing reserves. The best solution is to pass-through earnings on these funds to the banks that own the reserve accounts.

Certain arrangements presently permit reserve balances to serve dual purposes. Though counting vault cash against an institution's reserve requirement does not constitute earning a return, it does allow depository institutions to use a percentage of their reserve funds in order to conduct business. The DIDCA permits reserve balances held by certain depository institutions to be used to satisfy liquidity requirements that may be imposed under other provisions of federal or state law. The Act also provides that supplemental reserves may be imposed in specifically described circumstances. Such reserves would earn a return up to the yield on the securities portfolio of the FRS.

Congress decided against paying earnings on reserves in the past. It did so mainly because of the potential cost to the U.S. Treasury, but there were other considerations. Banks that held reserves received free services from the Federal Reserve, a valuable competitive consideration. Today, the Federal Reserve charges members and non-members for its services. Further, payment of earnings on reserves was considered to be out of step with industry practice, since banks were prohibited from paying interest on demand deposits. But the new deposit accounts, similar to demand deposits, pay a market rate of interest. Congress was also reluctant to pay earnings only to banks, but now all depository institutions hold reserves, including thrift institutions.

It is difficult to estimate how much impact the rebate of earnings on reserves would have on the U.S. Treasury. Although the MMDA and the Super-NOW accounts have attracted $333.3 billion as of April 6, 1983, depository institutions are not required to hold reserves on the estimated $283 billion(4) deposited in personal MMDAs.

The estimated $50 billion deposited in nonpersonal MMDAs(5) is subject to a three percent (3%) reserve requirement, while the $28.2 billion deposited in the Super-NOW account is subject to a twelve percent (12%) reserve requirement. However, these requirements are subject to at least the following exemptions:

- An amendment to Regulation D permits an institution to exclude its first $2.1 million in reservable liabilities. In effect, this provision exempts small depository institutions from basic federal reserve requirements. §12 C.F.R. Sec. 204.9(a)(2)†
- Under Regulation D, the first $26.3 million of an institution's net transaction accounts are subject to a three percent (3%) reserve ratio, and only amounts in excess of $26.3 million are subject to a twelve percent (12%) reserve ratio. §12 C.F.R. Sec. 204.9(a)(1)†
- In determining the required reserve balance, the average daily vault cash held during the computation period is deducted from the amount of the institution's required reserves. §12 C.F.R. 204.3(c)†

The impact on the Treasury would be further minimized by the taxes collected from higher interest income.

Consumers stand to benefit from the payment of earnings on reserves as they would realize either a higher yield on their deposits or a reduction of rates on loans. The payment of a market rate on a full transaction account would simplify the personal finances of consumers who could place all of their money in one account. Ultimately, the servicing costs on these accounts would be reduced as the consolidation of savings and checking

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4. Federal Reserve staff has indicated that 85% of MMDAs are personal deposits.

5. Federal Reserve staff has indicated that 15% of MMDAs are nonpersonal deposits

accounts would allow depository institutions to operate more efficiently and with reduced costs.

We also believe that the pass-through of earnings on reserves will increase the pool of reservable funds, since money would be drawn from sources that do not presently carry reserves. As a result, the Federal Reserve can improve its control of the money supply. In addition, as reserves invested in government securities grow, there would be a potential effect of lessening the need of the Treasury to purchase money in the open market.

H.R. 1013, legislation introduced by Representative Doug Barnard, Jr. (D-GA), would provide that a reasonable rate of return be earned on reserves held on the MMDA, the Super-NOW and future accounts authorized by the DIDC, and passed through to the depository institutions. Paying earnings on reserves will permit depository institutions to offer accounts that are "directly equivalent to and competitive with MMMFs." §Sec. 327 of Garn-St Germain Act†

DEPOSITORY INSTITUTIONS DEREGULATION COMMITTEE (DIDC)

CBA has actively represented our members before the DIDC seeking action that would permit depository institutions to compete more effectively in the financial marketplace. The recently authorized Money Market Deposit Account (MMDA) and Super NOW Account have permitted regulated financial institutions to offer needed products in the rapidly changing consumer financial services area. However, total deregulation is the only way to provide the competitive equality mandated by Congress, as it would recognize that non-federally regulated institutions are already offering these and other products.

CBA members believe that the next DIDC meeting, scheduled for June 28, 1983, is the proper time to remove all remaining interest rate ceilings on time deposits. We will urge the DIDC to reduce the minimum initial and balance requirements of the MMDA and the Super NOW Accounts on June 28, and to eliminate them entirely by January 1, 1984. In addition we will urge that an unlimited transaction account for businesses be authorized. These actions are necessary in order to achieve the intent of the Garn-St Germain Act: to ensure that financial institutions are able to "compete effectively" in the marketplace.

The state of the economy and the demands of the marketplace warrant the elimination of the rate limitations and the simplification of regulations for deposits now. The Administration's economic policies have reduced the rate of inflation. The Consumer Price Index gained only 3.9 percent last year, and may rise even less in 1983. We expect the economy will stabilize and the market will reflect these changes. The success of the MMDA and Super NOW Accounts, in attracting approximately $361.5 billion as of April 6, 1983, clearly indicates that consumers want to be paid market rates. If regulated financial institutions do not provide this service, others will, maintaining the disparate position of regulated entities.

As a result of the deregulation schedule adopted by the DIDC in March of 1982, rate ceilings have been removed from deposits with a maturity of two and one-half years or longer. The establishment of the MMDA and the Super-NOW Account permit depository institutions to offer interest rate deregulated accounts for maturities under 31 days. The elimination of all ceilings on time deposits would simplify the confusion caused by the present regulatory schedule and provide consumers with an opportunity to better fashion their savings activities. Further, total deregulation will give depository institutions the flexibility to better match their assets to their liabilities.

Some money market mutual funds offer accounts with initial and maintenance balances far below $2,500. Moreover, the money market fund authorized by the National Credit Union Administration has no initial deposit amount. The amount of these balances should be decided by the institutions. We will ask the DIDC to reduce these requirements at the June 28 meeting, and to eliminate them by January 1, 1984, so that depository institutions can offer products competitive with those offered by the non-regulated financial institutions.

The establishment of an unlimited transaction account for businesses would be another major step in the direction of "competitive equality" between depository institutions, as money market mutual funds already may provide businesses with these accounts. DIDC has yet to exercise its authority to establish a full-transaction MMDA available to all categories of customers. CBA believes that Section 327 provides DIDC with full authority to create such an account and that Congress intended that such an account be made available to all customers without discriminating between individuals and businesses.

In December 1982, a few days before the effective date for the limited-transaction MMDA, DIDC considered authorizing a second MMDA permitting unlimited transactions and available to all depositors. In response, some commentors argued that Super-NOW accounts cannot be extended to businesses because of the statutory restriction on NOW account authority to individuals and nonprofit entities. In addition, these commentors claimed that the payment of interest on demand deposits will be violated by a business MMDA with an unlimited-transaction feature.

CBA strongly believes that neither of these statutory provisions limits the authority of DIDC to authorize a full-transaction business MMDA. Though it is true that Section 303 of the 1980 Deregulation Act §12 U.S.C. Sec. 1832(a)† authorizes the payment of interest on NOW accounts only for individuals and certain nonprofit and governmental entities, DIDC has independent authority to authorize an account with unlimited transactions and a market rate of interest for other categories of customers. The adoption by DIDC of an unlimited transactions feature is clearly within the contemplation of section 327 of the Garn-St Germain Act, which directs DIDC to promulgate a deposit account that will compete effectively with the money market mutual funds.

Similarly, DIDC can authorize a full-transaction business MMDA under section 327 of the Garn-St Germain Act without violating the statutory restriction on the payment of interest on demand deposits §12 U.S.C. Sec. 371(a)†. Congress was fully aware of the demand deposit interest proscription when it enacted the NOW account authority in 1980 and the MMDA authority in 1982. In each instance, Congress recognized that it is possible to create a full-transaction account without making the account a demand deposit for section 371(a) purposes. Thus, for example, as long as DIDC mandates that depository institutions reserve the right to require seven days' prior notice of withdrawals, the new business MMDA would not constitute a demand deposit account. Such a reservation of rights has in fact been used in regulations promulgated for both the NOW account and the MMDA, to ensure that such accounts do not constitute demand deposits.

With respect to the section 327 authority, CBA believes that the unlimited transaction feature is essential to enable depository institutions to compete effectively with the money market funds for business depositors. In directing DIDC to create new accounts that would be "directly equivalent to and competitive with money market mutual funds," Congress emphasized the importance of the transaction features of the new account:

> The bank regulatory agencies must take into account in the design of the new instrument the fact that the most competitive features of the money market mutual funds are their low minimum balances, _their high liquidity in terms of withdrawals and their third party drafts, and the absence of reserve requirements on such funds (which gives them a cost advantage)_.

S. Rep. No 97-536, 97th Cong. 2d Sess. 19 (1982) (emphasis added).

In establishing a full-transaction account for individuals, through the Super-NOW account, DIDC recognized the significance of the unlimited-transactions feature in enabling depository institutions to fully compete with the money market funds. The need is particularly acute for small businesses that cannot effectively use cash management techniques and, thus, must rely on the money market fund accounts to maximize the income on their deposit funds. Therefore, to discriminate between individual and business customers ignores the mandate of the Garn-St Germain Act that all customers enjoy the benefits of competition, and prevents depository institutions from competing effectively with money market funds for a large portion of the current deposit account market.

Notwithstanding the existing statutory mandate for a full-transaction business MMDA, the DIDC has been reluctant to authorize such an account. More than one DIDC principal has expressed concern about comment letters questioning the ability of DIDC to authorize such an account in light of the statutory proscription on the payment of interest on demand deposits. In 1982, the DIDC needed a congressional "push" to proceed with deposit account deregulation. Additional congressional encouragement of DIDC action may now be necessary to enable depository institutions to realize the competitive equality in pursuing business customers envisioned by section 327. Indications of congressional approval for the full-transaction business account will also silence those who seek, for their own competitive advantage, to discourage or delay the availability of any truly competitive business MMDA.

In view of the operational changes necessitated by these proposals, we will ask the DIDC to make appropriate actions effective as of January 1, 1984.

These actions are necessary and should be brought up at the June 28 DIDC meeting. Once accomplished, we strongly support the comments of the DIDC Chairman Donald T. Regan before this Committee on April 6, 1983, when he stated that it "...may be time to consider bringing the work of the DIDC to an end... ."

We hope that this Committee will indicate its support for Secretary Regan's position.

RELATIONSHIP OF FEDERAL DISCLOSURE REQUIREMENTS TO STATE LAW

Though this Committee made great strides to simplify Truth in Lending in 1980, the provision governing the extent to which state law would be preempted was weakened rather than strengthened. The limited preemption rule in the present law leaves most state disclosure laws intact, so that creditors must comply with both state and federal disclosure laws. This double responsiblity makes form design and execution problematic, and subjects creditors to possible double sanctions for violations. The overlay of state disclosure laws on top of the Truth in Lending rules produces disclosures that are lengthy, redundant and confusing to consumers.

The TILA provides that state disclosure laws are preempted only to the extent they are "inconsistent" with federal law. Section 226.28(a)(1) of Regulation Z paraphrases the Act to preempt state law "if it requires a creditor to make disclosures or take actions that contradict the requirements of the federal law." The Regulation and the Commentary provide some examples indicating that this is a very limited preemption rule, and disclosures of additional, different or more detailed information under state law do not usually contradict the federal rules.

The Federal Reserve Board has had occasion to apply these criteria to specific provisions of several state laws. In the course of that exercise the Board staff further refined the test: state law is preempted "if it significantly impedes the operation of the federal law or interferes with the purposes of the federal statute." The operative test has now been expanded from "inconsistent" to include "contradict," "impede" or "interfere."

Applying this standard, the Board staff stated three principles that will guide preemption decisions: (1) terminology used in a state disclosure law is presumed to be required terminology in transactional disclosures; (2) a state disclosure term is not subject to preemption unless it is the "functional equivalent" of a TIL disclosure item; and (3) state law requirements are preempted only in particular transactions where inconsistencies occur.

The net result is that the present TIL preemption standard is very narrow. Absent flatly contradictory terminology, the federal Act has no effect on state disclosures that are not "functional equivalents" of federal disclosures. The state disclosures that are functional equivalents are preempted only in those cases where actual conflict arises, i.e., where state law numbers or terminology are incompatible with the TIL disclosure. At the same time, when a state law item _is_ preempted, it is totally barred; it may not appear anywhere in the transaction documents, not even separately from the TIL disclosures.

The present Regulation also contains a protective compliance rule for creditors: a creditor may continue to make all state-required disclosures until the Board staff determines that they are preempted. This avoids possible exposure to liability under Regulation Z, but does little to encourage simplified or streamlined forms.

Another formula against which the various state laws could be evaluated is found in S. 1720 of the last Congress. This proposal seems designed to be more broadly preemptive than present Regulation Z.

Under this proposal the threshhold question of which state laws are preempted must be answered in two steps:

1. Is the state law "similar in nature, purpose scope, intent, or effect" to TIL?
2. If so, does the provision at issue require anything "different" than TIL requires?

The breadth of the language used in the Senate proposal presents interpretational problems. A host of state laws could be "similar" to TIL under one or more of the five terms that are set out in the alternative. For example, the entire Uniform Consumer Credit Code is similar to TIL in "scope," i.e., range of transactions covered. Further, does one look at an entire state statute to make the initial determination of similarity, or does one apply that test provision by provision? Two assumptions should be made with regard to the language: (1) state laws must be analyzed section by section; and (2) a state provision satisfies the "similar to" test if it requires creditors to give any specific information about the terms of closed-end credit transactions, or about the terms or activity of open-end credit plans.

Within the probably large class of state law provisions, there are candidates for preemption under the first-stage critera; the Senate proposal zeroes in on those provisions that "differ" from TIL in the specified ways. On analysis it is not clear whether this language really narrows the preemptive effect. Apparently any state law disclosure would be preempted if it varies in any manner — "scope, content, form, terminology, placement or timing" — from the TIL rules.

This proposal could have an important effect on creditor liability. Consider a state that adopts the TIL rules as state law (explicitly, or by incorporation by reference, or by use of an "equivalency" provision) and provides a separate or larger penalty for violations. Under the Senate proposal, state law rules are preempted only if "different," and not if they are identical. State law rules that are the same as TIL remain in place. Though in this case the creditor's compliance burdens would be satisified by a single disclosure, the creditor could be exposed to separate or multiple sanctions for violations.

The variety of state laws having disclosure implications is enormous. The laws dealing with transactional disclosures similar to TIL differ in content and level of detail. They differ in timing and form. There is also a large number of state laws that require communication of credit information to consumers that is only marginally related, or not related at all, to the information required under TIL. For example, there are disclosures about escrow accounts, annual totals of finance charges paid under open-end accounts, mandatory receipts for payments, foreclosure procedures and other post-contract rights.

This array of state law is rarely internally organized or systematic. Disclosure requirements appear in rate regulation laws, licensing statutes, insurance codes, special consumer protection laws, the Uniform Commercial Code and state agency regulations. Some are brand new (such as the California requirements for itemization of the amount financed); some are quite old (pawnbroker statutes, for example). These differences confirm that the state disclosures are usually part of a larger regulatory scheme that has purposes considerably broader than TIL.

At the same time there are recurring patterns of disclosure rules from state to state. The retail instalment sales acts are probably the clearest example. No two state retail instalment sales acts may match exactly, but they are all quite comparable in scope and content. Some track old Regulation Z, but have not been updated, creating special preemption questions.

It is probably impossible to capture in a short phrase or sentence a workable preemption rule for TIL disclosures. For example, one can readily understand the mechanics of how California's mandatory itemization of the amount financed relates to TIL: one is required, the other optional; the state rule requires more detail than the federal optional disclosure. But does this argue (1) that the California rule should be absolutely preempted in the interests of avoiding information overload, (2) that the state rule should be unaffected as not "contradicting" the federal rule or (3) that creditors should be free to omit or include the state information as they see fit?

Additionally, the "contract validity" issue is something of a red herring. It is virtually impossible to readily tell whether a particular state disclosure has substantive contract implications. Some obviously do not; many probably do, in some fashion. For example, in a typical loan contract, the parties will need to set out somewhere the basic terms (amount of loan, charges and fees, payment schedule) in order for a court to recognize the contract as an enforceable agreement. Sometimes the disclosure statute will say or intimate that all specified terms must be included or the contract is unenforceable. Moreover, our legal system generally gives the parties to a contract considerable freedom to amplify their agreement in as much detail as they wish. If, for example, the parties choose to itemize the finance charge, they have decided that their contract requires that detail. Through whose eyes is the contract validity question to be viewed: the parties', a court's, the state legislature's?

This suggests that there is still a fundamental conflict underlying the preemption issue that may be unresolvable without major restructuring of the nation's consumer credit laws. The conflict is between the limited goals of TIL (standardized disclosure) and state law that incorporates disclosure features into broad-based regulatory schemes. Unless Congress is willing to preempt those state regulatory systems in their entirety, the alignment of federal and state disclosures can probably never be smooth.

The present Regulation Z as construed by the Fed staff has the least possible preemptive effect on state laws. State disclosures are displaced only in cases where there is "contradictory" terminology or meaning. Virtually any state disclosure that calls for different, additional or more detailed information remains intact. So too, apparently, does a state law that requires or prohibits what Regulation Z makes optional. In the actual interpretations to date, the formula has been applied only to individual disclosure phrases out of state statutes; it is not at all clear how it would be applied to nondisclosure requirements, such as state law rescission mechanisms.

Perhaps the major disconcerting effect of the present formula is its "swiss cheese" effect on creditor forms. Some state disclosure items will remain, others will be preempted and still others are preempted only if transaction details make them contradict federal disclosures. Already there are potential inconsistencies in the Fed formula. For example, "rate at which the finance charge is computed" is not preempted, but "time price differential" is preempted where it equals the TIL finance charge. What then of a state disclosure of the "rate of the time price differential to be charged"?

Nor does the present standard clearly resolve noninformational aspects of state law, such as disclosure format or timing. Although the present formula defers generously to state law, it may create nightmarish interpretational and compliance problems, to say nothing of lengthy, redundant disclosures.

The Senate proposal is structured like that in Old Reg Z, Section 226.6(b)(2)(i), for the error resolution procedures. That is, if a state law is "similar in nature, purpose, scope, intent, effect or requisites," then that law is preempted to the extent it imposes "different" requirements. This approach is probably adequate in that procedural setting, but is more doubtful with respect to disclosure. In the main, it would appear to very broadly preempt state law with a lack of clarity as to its boundaries. For the same reason, as a statutory standard, it would impose an immense interpretative load on creditors (or the Fed), and would not necessarily shorten credit contracts so long as creditors were free to re-incorporate any superseded state disclosure.

In addition, as noted earlier, state laws identical to TIL would not be preempted under this formula, so the prospect of double liability would remain.

Possible Alternatives

In general terms, the appropriate function of a preemption rule would seem to be to identify the core purposes of the federal law, and then to make sure that state law rules do not unduly disrupt or interfere with those federal goals. At some risk of over-simplification, the core purposes of the TIL disclosure rules might be stated as follows:

1. To assure that consumers in closed-end transactions receive certain credit information (but not all possible credit information) before consummation, in a distinctive format, with some distinctive terminology and without excessive detail.
2. To assure that consumers in open-end plans receive

certain credit information (but not all possible credit information) about the plan when it is established, and at specified points thereafter, without excessive detail, without a rigid format and with very little distinctive terminology.

3. To do the above in a manner likely to maximize consumer understanding and use of the information disclosed, while also minimizing creditor compliance burdens.

This suggests certain premises for further analysis. Swiss cheese forms seem inherently dysfunctional; so do disclosure statements and contracts that contain "inconsistent state disclosures" labeled as such (as the prior regulation permitted). So also do documents that simultaneously break out contract details in one fashion for federal purposes and in another form for state purposes. Conflicting terminology is another obstacle. Finally, state disclosures of additional, non-duplicative information may lengthen contract paperwork and create confusion if provided at different times and in different forms.

State disclosures that create these problems should therefore be barred, or at least discouraged. Two approaches suggest themselves.

Alternative 1. One possibility would be to borrow the idea of the state "equivalency provisions" that have been enacted in several states. Essentially, an "equivalency provision" provides that federal TIL disclosures can be substituted for required state disclosures. Thus TIL would say, in effect, that any creditor who complies with TIL cannot be held liable for failing to comply with any state law requiring disclosures comparable to TIL in content, terminology and time of delivery. This would remove the threat of state liability for nondisclosure, and it would do so nationwide without depending on the state legislatures to enact and update specific provisions on their own.

What this approach does not do, however, is mandate the deletion of the state disclosures. The creditor is protected if the state disclosures are omitted, but is free to continue to make them if it chooses.

Alternative 2. A second alternative approach might be called the "laundry list" method. This would seek to group state disclosure laws in a manageable number of discrete categories and then list specifically which categories are preempted and which are not. Those that were preempted could be completely barred from the transaction, as the present Reg. Z does for contradictory state disclosures, or a safe-harbor feature could be attached to certain categories where the creditor ought to have the option, but not the obligation, to make the state disclosures.

Compiling such a list may not be all that difficult once the state laws are fully canvassed. For example, some of the categories that emerge include state laws that:

1. Require transactional disclosures identical in content, form and timing to TIL.
2. Require disclosure, but with a different breakdown or different terminology, of all or part of the TIL finance charge, amount financed, annual percentage rate, payment schedule and total of payments, or (in the case of open-end credit) all or part of the information required for initial or periodic statements.
3. Require itemization, or listing of components, of TIL disclosures (e.g., downpayments, amount financed).
4. Require certain formalities for the contract instrument itself (in writing, signed, delivered, names of parties, description of goods sold, etc.).
5. Require generalized warnings, labels or captions, without specific credit information.
6. Call for payment receipts, statements of account or other information of an after-the-fact accounting nature (other than open-end periodic statements).

7. Require explanations of insurance coverages and claims procedures.

8. Require post-contract disclosure of rights (e.g., cure notice, foreclosure and resale notices, releases).

9. Require explanations of creative finance features.

Once the categories are listed and refined, there is only the policy choice of which categories should be preempted and which should not. Such an approach would add much more certainty and predictability to the preemption area than now exists, but it would not be perfect. Some state laws would defy easy categorization. Within a single provision of state law, one phrase might fit one category while another phrase would belong in another grouping, with the result that some swiss cheese forms might continue. This also tends to be a piecemeal approach that never quite addresses the underlying problem that the combination of federal and non-preempted state disclosures may present a redundant or impenetrable mass of contract information.

The Association urges the Committee to hold hearings explicitly on this subject in order for us to further discuss this matter.

TRUTH IN LENDING:

CIVIL LIABILITY PROVISION

The 1968 Truth in Lending Act (TILA) was enacted in order to provide meaningful and comparable credit cost disclosure information, to foster consumer awareness of the cost of credit and credit terms and to facilitate shopping among credit sources. The civil liabililty provision was incorporated to encourage creditors to comply with the TILA and to allow consumers to act as private attorney generals.

Prior to the legislation, it was recognized that less than half of the 40,000 creditors in the United States were subject to compliance examinations as provided by the federal financial regulatory agencies. Congress believed that rather than creating a federal enforcement agency, a civil liability structure should be established to encourage consumers and private attorneys to prosecute suits against non-complying creditors.

The civil liabilty provision provided that consumers could collect actual damages and civil penalties of twice the finance charge with a minimum recovery of $100 and a maximum of $1,000. Most important, the consumer could be reimbursed for reasonable attorneys' fees and court costs from the creditor.

This provision became a magnet for harassing lawsuits. More than 13,000 suits have been filed in federal courts alone during the last 14 years, often based upon hyper-technical and non-substantive requirements of the TILA. The allegations often involve nothing more than technical violations of matters that do not bear on credit cost disclosures or the ability to shop for credit, and merely impose penalties on creditors unable to chart varying court interpretations.

A number of court decisions have acknowledged the non-substantive aspects of the suits, but have also assessed penalties because they are mandated under the TILA. Below is a sample of what some courts have said regarding their discretion when hyper-technical or miniscule violations are involved in a case:

In Kessler v. Associates Financial Services Co., 573 F.2nd 577, 578 (9th Cir. 1977), the court stated:

> We share the district court's concerns that the vagaries of

> the construction of TILA and Regulation Z can be traps for even wary lenders ... as real as those concerns are, however, redress lies with Congress and the Federal Reserve Board, not with the Courts.

In Sun America Finance Corp. v. Williams, 442 N.E.2d 83 at 86 (Ohio App 1981), the court stated:

> (O)nce a creditor violation of Truth-in-Lending requirements is proven, liability follows absolutely and the debtor must be awarded damages ... . However much we may disapprove of this aspect of the scheme adopted by Congress, because of its oftentimes effect of working what we, as judges, perceive to be unjust results in individual cases, we nonetheless are compelled to apply the law as it has been written or as it may reasonably be construed.

In Anderson v. Farmers Bank of Clatonia, 640 F.2d 1347, 1349 (8th Cir. 1981), the court noted that:

> There is ... no contention that the violation was anything but technical - the (debtors) admittedly suffered no damage as a result of the violation.

In Brown v. Providence Gas Co., 445 F.Supp. 459, 465 (D.Ct. R.I. 1976), the court stated:

> (We) would hope that an already overcrowded docket will not be further exacerbated by "Consumer Credit" cases premised on the presence or absence of talismanic verbiage, in deciding whether there is compliance with the disclosure policy of the Act. Such tactics serve no useful purpose to the consumer, creditor, Congressional intent or the Court.

In Powers v. Sims & Levin Realtors 396 F.Supp. 12 (E.D. VA. 1975), aff'd in part, rev'd in part, 542 F.2d 1216 (4th Cir 1976). The defendant's disclosure statement read as follows:

FINANCE CHARGES

Interest	$2,093.15
Brokerage	250.00
TOTAL FINANCE CHARGES	$2,343.15

The violation in this case was based on the fact that the label "Total Finance Charges" should have been labeled "Finance Charge."

We have a number of additional court cases, reaching similar conclusions, and will summarize the results further upon request.

In 1980 Congress passed the Truth in Lending Simplification and Reform Act, in part to address these problems. That Act had several objectives, which included simplification of TILA disclosures and reform of the statute to reduce litigation. The Congress tried to reduce litigation by rewriting sections of the TILA that had been the focus of law suits, and by reducing the number of items upon which a credit granting institution could be sued. However, the limitations on liability are very narrow and creditors still can be sued for the slightest variance of any of the following items:

Open End Credit - Initial Disclosure Statement

1. The conditions under which a finance charge may be imposed
2. The method of determining the balance upon which a finance charge will be imposed
3. The method of determining the amount of the finance charge
4. Where one or more periodic rates may be used to compute the finance charge, each rate, the range of balance to which it is applicable and the corresponding nominal annual percentage rate should be disclosed
5. Identification of other charges which may be imposed
6. Where the credit is or will be secured, a statement

that the security interest is or will be taken in, the property purchased or property not purchased must be identified by item or type

7. Providing a billing right statement

Open End Credit - Periodic Statement

1. The amount of any finance charge
2. The one or more periodic rates used to compute the finance charge
3. The Annual Percentage Rate
4. The balance on which the finance charge was computed and a statement of how the balance was determined
5. The outstanding balance in the account at the end of the period
6. The date by which or the period (if any) within which payment must be made to avoid additional finance charges
7. The address to be used by the creditor for the purpose of receiving billing inquiries

The hyper-technical nature of the TILA regulations, which have created numerous problems, can be traced directly to the civil liability provision. Under the former Regulation Z, the creditor community, in order to assure compliance, sought and received over 1,100 unofficial staff interpretations, more than 200 official staff interpretations and more than 40 Board interpretations. This volume of regulatory interpretations, plus new and novel interpretations of the Act as a result of the unprecedented number of lawsuits, caused the former regulation to become as complicated as the Internal Revenue Code. Even large creditors with sophisticated legal departments believed that compliance was virtually impossible.

The Fed has drafted the new Regulation Z in a far more logical and simplified manner. Interpretative letters have been eliminated and a staff commentary on the regulation has been issued, which is over 100 pages in length and is updated annually. However, lenders are still confronted with significant civil penalties for any hyper-technical violation or an enforcement agency-ordered restitution for minor mistakes. There continues to be a legitimate concern about this liability. Therefore, prudent counsel have felt compelled to seek definitive interpretations of the Regulation from the Board staff.

The Board itself has recognized this problem. On April 28, 1981, Vice Chairman Frederick H. Schultz testified before this Committee that the civil liability provisions are:

> Often a major contribution to regulatory complexity .... . Although financial institutions should be expected to follow the law scrupulously, the problem with disproportionately severe penalties is that they compel the Board to articulate extremely detailed rules governing every facet of regulated conduct. In giving the requested protection, compliance for everyone is made more complex.

This testimony was presented well over a year after Congress had made modest amendments to scale down Section 130 liability. We believe that the essence of Governor Schultz's suggestion could be achieved by modifying the Act's civil liability provision.

This suggestion is supported by Chairman Volcker's statement on October 9, 1981 before this Committee regarding the penalties provision. He explained that the:

> ... large volume of litigation is one major reason for the complexity of Regulation Z, as creditors try to protect themselves against a variety of sometimes conflicting court decisions by obtaining large numbers of interpretations from the Board.

Since 1969 the Board staff has worked strenuously to try to make the TILA work effectively. The hundreds of interpretations did not solve the problem, and the Staff Commentary is probably the proper approach to provide these needed interpretations.

However, the underlying problem has not been solved. We believe that the desired simplification cannot be achieved until there is an end to the automatic imposition of civil penalties for hyper-technical mistakes or novel legal theories unforeseen by the Board, the creditor community or Congress.

In S.1720, introduced in the last Congress, Senator Garn suggested that the better approach would be to have the courts look at the contract and disclosures as a whole and determine if they were in "substantial non-compliance" with the Act or Regulation.

We believe this to be the preferable approach. Courts should be given the discretion to review all the disclosures subject to the civil liability penalty provision and reward or deny recovery when based on whether or not the transaction is in substantial non-compliance with the purpose of the TILA.

We believe that the present penalty structure of twice the finance charge with a minimum of $100 and maximum of $1,000 is too arbitrary. We support Senator Garn's approach of allowing the court to impose a civil penalty of up to $5,000. However, since numerous TILA suits have been filed based on trivial, non-substantive matters, a civil penalty of $1,000 might be more appropriate.

The final amendment relates to the ability of a plaintiff to have double recovery for single violations. In many instances a violation of federal law is also a violation of state law. We believe that punitive damages should be collected only once.

RESCISSION

Although the Truth in Lending Act (TILA) traditionally has been viewed as a credit cost disclosure statute, it also contains a few sections that provide substantial consumer protections. Though a review of all such provisions is warranted, the rescission provision is in particular need of revision. Over the past 14 years this provision has been the source of significant customer confusion and irritation, and of compliance problems for banks. It is the most infrequently used consumer protection provided under the TILA.

The rescission provision, Section 125 of the TILA, provides that any consumer whose dwelling secures an extension of credit that is not for acquisition or construction can rescind that transaction up to three days after certain events occur. Those events are the creditor's delivery of all "material" Truth in Lending disclosures; delivery of two copies of the forms to the consumer for rescinding the transaction; and the consummation of the transaction. Once all three events have occurred, the three-day period begins to run. The provision also requires providing copies of the rescission forms to anyone with recognizable interest in the dwelling. Obviously, providing these forms imposes additional operating costs that ultimately are passed on to all consumers. During the three-day period no funds can be disbursed to the consumer. Since rescission can be exercised by mail, the Federal Reserve Board Staff Commentary indicates that creditors should either wait longer than three days or require all consumers who received the rescission notice to sign a statement indicating that they do not intend to rescind the transaction.

Since customers have already gone through the application process, credit review and necessary steps to create a mortgage, they find this three-day delay to be unreasonable.

Also, in 1978, when this Committee was considering the Truth in Lending Reform and Simplification Act, the CBA conducted a survey of its members regarding the use of rescission. The results of the survey indicated that the rescission right was rarely, if ever, excercised. A few banks reported that it occurred only once or twice a year.(6) The expense of providing the forms and the delay in making funds available cannot be justified under any cost/benefit analysis.

In reviewing the underlying policy reasoning for adding this provision to the proposed TILA in 1968, we find that it does not justify application of this requirement to direct bank loans. When TILA was under consideration on the House floor, Congressman William T. Cahill (R-NJ) offered an amendment giving the customer the right to cancel transations involving second mortgages (see Cong. Rec., January 31, 1968, H. 631). In explaining the need for the amendment, he noted that homeowners were being defrauded by home improvement salesmen and that the consumer never received a credit-cost disclosure to show that the interest rates on these transactions were running 30 to 40 percent, or that a lien was being taken on the consumers' homes. Subsequently, the closed-end disclosure requirements under Regulation Z require that this information be provided to the consumer in separate segregated disclosures before the transaction is consummated.

Second, Congressman Cahill noted that since brokers were arranging

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6. CBA is again surveying its membership on this issue. When the survey is completed a copy of the results will be provided to the Committee.

these transactions, the consumer was unaware that the loan would be sold to a finance company. We would note that this Committee voted last year to remove brokers or "arrangers of credit" from coverage under the TILA. However, FTC trade regulation rules on door-to-door sales and similar state laws now have filled any enforcement gap.

Third, he explained that lending institutions that bought paper from contractors and other merchants who engaged in fraudulent tactics could be insulated from consumers' claims and defenses under the holder-in-due-course doctrine. However, in November 1975, the FTC promulgated a trade regulation rule on "Preservation of Consumer Claims and Defenses." This rule effectively wiped out any state laws allowing the application of the holder-in-due-course doctrine to credit sales involving consumers. Therefore, this concern is no longer valid.

Senator William Proxmire (D-WI) confirms our interpretation of the public policy intent behind the Cahill amendment. On February 2, 1968, Senator Proxmire indicated that the provision was aimed at fly-by-night contractors who provide shoddy home improvement work (Cong. Rec,. February 2, 1968, S. 821). Moreover, when the Conference Report came before the House, the author of the legislation, Congresswoman Lenore Sullivan (D-MO), indicated that the rescission provision was intended to stop "home improvement racketeers". (see Cong. Rec,. May 22, 1968, H. 4118).

The legislative history is abundantly clear that the rescission provision was aimed at credit sales by contractors, rather than at direct loans by banks. Under a basic cost/benefit analysis as well as for sound public policy reasons, we urge this Committee to recognize that the three-day rescission requirement should not apply to direct loans.

CRIMINAL LIABILITY IN CONNECTION WITH CREDIT AND DEBIT CARDS

In recent years there has been a dramatic increase in the types of crimes associated with credit and debit cards. The Consumer Bankers Association (CBA) believes that the growing incidence and scope of criminal activity require an equally comprehensive response. We believe that this major problem should receive specific attention from the Judiciary Committee in order to provide a complete statutory treatment of this expanding problem.

CBA does believe, however, that there should be certain minor changes in existing criminal provisions that are now contained in both the Truth in Lending and the Electronic Fund Transfer Acts. The first of two modifications involves including account numbers as well as actual plastic cards among the items protected by the criminal provision. The second involves what might be confusing ambiguity in the statutes with respect to the aggregation of the values of goods and the use of one or more cards or devices.

The first suggested amendment is mandated both by changes in technology and a new area of fraud that recently has given rise to substantial losses. This involves the fraudulent use of account numbers that often can be used without any card or device issued with respect to the account. For instance, a perpetrator might call an unsuspecting consumer and, through a variety of ploys, obtain the consumer's account number. Account numbers can also be obtained from discarded carbon paper that will reveal the number upon close examination. These account numbers may then be used in a number of ways, including the purchase by telephone of goods or services, which are charged to the unsuspecting consumer's account. The very earliest point at which the fraud can be discovered is when the consumer receives a periodic statement reflecting the fraudulent activity. In most cases, by that time the perpetrator has obtained the goods or services and is long gone.

The new amendment would simply recognize that account numbers are another way of gaining access to the account. It would then cover their improper use in the criminal provision. Though a reasonable reading of the existing statute might suggest that the current provision should already be read in this manner, at least one court has ruled that this is not the case. We believe that this potential loophole should be corrected through very limited amendments to Section 134 of the Truth in Lending Act and to Section 916 of the Electronic Fund Transfer Act.

The second and far more technical amendment that we suggest relates to the calculation of certain dollar amounts relating to fraudulent use. In establishing a threshold amount to trigger liability, the existing statutes provide that transactions must involve at least $1,000 and the use of a credit or access device. The technical question that has arisen is whether the $1,000 amount must be met with respect to a single transaction, or whether it relates to one or a series of transactions. Similarly, there has been some confusion as to whether the test can be met with more than one card or device, or whether it is limited to a single card or device. In this area, the limited judicial attention that has been paid has produced the clearly appropriate conclusion that the current language should be read as including "one or more," both with respect to transactions and to cards or devices. Despite that judicial recognition, CBA believes that the criminal provisions of these two statutes should be amended to make absolutely certain that fraudulent activities will not escape prosecution on the basis of this possible loophole.

In addition to these two amendments, we urge the members of this Committee to support legislation that we hope will be forthcoming to deal in a more comprehensive way with the increasingly pervasive problem of credit and debit card fraud. CBA is working with other associations and organizations in an effort to develop and obtain passage of legislation to deal with this problem. We fully support the comprehensive effort being advanced by the unified card industry to add a new chapter to Title 18 of the United States Code to deal with fraud, counterfeiting and related areas of criminality now affecting the credit and debit card industry.

DELAYED FUNDS AVAILABILITY

Mr. Chairman, the issue of delayed funds availability has recently received some attention by this Committee. The Consumer Bankers Association recognizes the problems associated with the practice by some banks of placing "holds" on checks deposited to customer accounts. Banks place holds on customer deposits depending on factors such as the location of the depository bank and the account relationship with the depositor. Generally, many banks pay interest on consumer deposits in interest-bearing accounts regardless of whether a hold is on those deposits.

The major reason for delays in the availability of funds stems from a structural problem in our present payment system. The check processing system operates very efficiently, since it is a mechanical system in which checks are collected for payment on an automated basis. However, returned or dishonored checks require manual processing, which can result in a substantial delay before the bank of first deposit is notified that a check forwarded for collection has been dishonored.

In addition to manual processing of returned or dishonored checks, the present methods of check endorsement make the identification of the bank of first deposit almost impossible to ascertain. Thus, all dishonored items must be returned through the same chain of institutions from which they originated. This problem is further complicated by Section 4-212(2) of the Uniform Commercial Code, which has been adopted by all states. This provision requires a dishonoring bank to return an item through the same series of banks by which it came.

In 1981, the American National Standards Institute issued a report entitled Specifications For Check Endorsements. This study provides specifications for standardized endorsements in order to facilitate the automation of returned checks. In reviewing these recommendations, CBA has concluded that the costs associated with implementing these standards would be prohibitive in light of other alternatives available. Since we are rapidly moving toward an electronic payment system rather than a paper based system, we believe that major costs to improve the return process should be concentrated in the electronic area.

CBA opposes setting national standards for funds availability. If arbitrary time limits are set, it will mainly benefit those who want to take advantage of the system through check kiting, and will not be reflective of the actual time periods involved in the check collection process.

We strongly recommend voluntary disclosure of delayed funds policies by depository institutions. In fact, our Association has adopted a resolution urging our members to focus on consumer concern for delayed funds availability. This resolution urges all financial institutions "to adopt a uniform written policy that articulates the reason for delays," which "should be communicated to all employees and customers."

We recognize that our efforts will not immediately end the problems caused by delayed funds availability practices. However, as bank policies and practices are clarified and the electronic technology advances, we believe that this problem will eventually be alleviated.

CBA would be happy to discuss this issue with you further in order to receive any suggestions and assistance you can provide.

CONCLUSION

Mr. Chairman, two years ago at this time you held a similar set of oversight hearings, which lead to the Garn-St Germain Act. This Act, driven by the prospect of a failing thrift industry, revolutionized the thrift financial world. In our opinion, entities that operate under the supervision of the Federal Home Loan Bank Board have essentially the same powers as commercial banks. With the era of intra-industry squabbling behind us, we hope that the regulated financial industries can unite in the goal of achieving parity.

As we have pointed out numerous times throughout this testimony, disparate treatment to similar providers of financial services by federal law can no longer be justified on economic, market or social policy grounds. Whether or not this Committee acts, the revolution will continue. The question is: will Congress wait for another crisis to occur before enacting legislation? We watched the crisis caused by disparity that led to the passage of the Monetary Control Act and the creation of the DIDC and the Money Market Deposit Account. We urge you to act now and establish an orderly realistic framework for the financial services market. Moratoriums like price and credit controls only distort the market and are simply used as a panacea by those who refuse to face the underlying problems.

CBA hopes these hearings will lead to major deregulation legislation that has been the hallmark of this Committee.

Senator **Gorton**. Thank you very much, Mr. Hammer.

Now, Mr. Patterson, we've reached you.

STATEMENT OF RICHARD P. PATTERSON, SENIOR VICE PRESIDENT, INTERFIRST BANK, DALLAS, TEX., PRESIDENT, DEALER BANK ASSOCIATION

Mr. **Patterson**. Thank you. I'm Dick Patterson, senior vice president of InterFirst Bank of Dallas, and I'm appearing today as president of the Dealer Bank Association.

[Complete statement follows:]

TESTIMONY OF

RICHARD P. PATTERSON

PRESIDENT

DEALER BANK ASSOCIATION

SENIOR VICE PRESIDENT

INTERFIRST BANK DALLAS, N.A.

DALLAS, TEXAS

BEFORE THE

SENATE BANKING COMMITTEE

MAY 3, 1983

Mr. Chairman and Members of the Committee I appreciate the opportunity to testify today on behalf of the Dealer Bank Association, a trade association of 175 banks from all over the country that underwrite and trade in public securities as well as other money market instruments.

The Association supports efforts by the Congress and by the Administration to reduce or eliminate outdated legal barriers to increased competition among providers of financial services. We believe that the increased competition that comes from product deregulation, and the efficiencies that can be achieved by procedural deregulation, will benefit the public. As the Committee knows, the special concern of our Association has long been securities issues, particularly the underwriting of municipal revenue bonds by banks. Indeed, this is the fourth time in two years that a representative of the Association has testified before this Committee on this issue, and the issue itself has been before the Congress for more than 20 years.

The Association urges the Congress to take prompt action to amend the Glass-Steagall Act to permit banking organizations to underwrite public purpose municipal revenue bonds. The principal public policy reason for passing this legislation is that it will save the issuers of municipal revenue bonds -- state and local governments and their taxpayers -- many millions of dollars without any increased cost to the federal government. In an era of cutbacks in federal assistance programs for state and local governments, and when the infrastructure needs of our states and cities are great and growing, it is particularly important that the Congress act promptly to remove the artificial barriers that now exist to full competition in the municipal revenue bond market.

Over the coming months the Committee will be considering a wide range of Glass-Steagall issues, some of which will raise fundamental questions concerning the precise roles banks and broker/dealers should play in our economic system. The revenue bond issue is different. It does not present any fundamental Glass-Steagall policy issue. Municipal revenue bonds are public securities of the sort that banks have underwritten for more than 50 years. From its inception, the Glass-Steagall Act has specifically permitted banks to underwrite federal government and municipal general obligation bonds. As the Secretary of the Treasury has told this Committee, the legal prohibition on banks underwriting municipal revenue bonds is an historical ~~event~~ accident -- an accident that reflects the fact that municipal revenue bonds were virtually unknown in 1933. Today the market has changed dramatically. In 1982 municipal revenue bonds accounted for 70% of the long-term municipal securities market. It is long past time to modernize the law to reflect the realities of the marketplace.

Congress has amended the Glass-Steagall Act at least 15 times in the last 30 years to permit banks to underwrite specific public securities -- ranging from the TVA to the Asian Development Bank. And in 1968 Congress amended Glass-Steagall to permit banks to underwrite housing and university-related municipal revenue bonds. This history is critically important. It demonstrates that the Congress has recognized the need of public issuers to achieve a broad, efficient and low cost market for their securities. And it demonstrates that banks and broker/dealers of all sizes and in all geographic regions can compete in the municipal revenue bond market fairly and efficiently, without adverse effect on either, and in the public interest.

The realities of the marketplace also show that the notion that banks have advantages that will allow them to dominate any market in which they compete has no basis in fact. (The municipal bond market today is dominated by the broker/dealers. The leading underwriting in 1982 was Merrill Lynch. No bank is among the top ten underwriters in the long-term municipals market. And broker/dealers have 57% of the general obligation market, where they and banks compete head to head under current law.[1])

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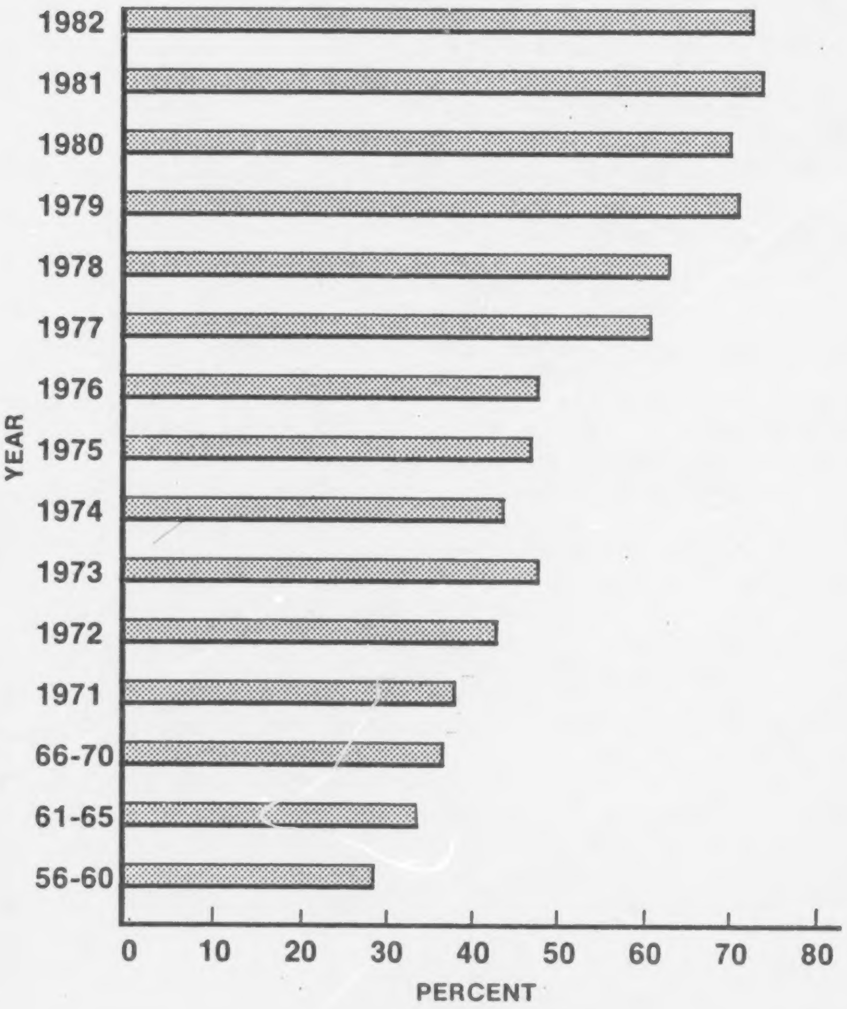
[1] From an unpublished 1983 comparative report on the largest 25 managers; Morgan Guaranty Bank.

The Dealer Bank Association has long urged that revenue bond underwriting authority be granted directly to banks -- as public securities authority was granted directly to banks in the Glass-Steagall Act itself -- and that a separate subsidiary of the bank holding company should not be required for the underwriting of municipal revenue bonds. The Association is now prepared, however, to support legislation that grants new revenue bond authority only to a separate subsidiary of the holding company. We came to this conclusion for three reasons. First, the separate subsidiary approach may command a broader range of support in the Congress, thereby permitting prompt legislative action that would open the market to full competition. Second, the separate subsidiary approach should lay permanently to rest the ancient canards -- unfair competition, conflicts of interest, tax or regulatory advantage -- that have been used by the broker/dealers to keep banks out of the market for many years. Finally, the separate subsidiary approach establishes a framework for subsequent legislation that will increase further the range of financial products that banking organizations can offer their customers. Thus, while the separate subsidiary approach imposes some inefficiences and other costs on banking organizations, the Association believes it offers the best prospect for legislation in this Congress.

If banks are to have separate subsidiaries for their securities activities in the name of a "level playing field," then the field ought to be level. For example, the separate subsidiary should not be subject to any more restrictive rules and regulations than broker/dealers are. And securities firms -- including the giant financial conglomerates -- should be subject to the same interaffiliate and anti-tying restrictions as are bank holding companies. In addition, legislation should grant to the separate subsidiary the full scope of revenue bond powers, including at least all public purpose municipal revenue bonds even if they are technically industrial development bonds under the Internal Revenue Code. The grant of these powers is necessary in order to permit the separate subsidiary to compete with broker/dealers, which will still have the advantage of being able to offer their customers a full range of securities, including corporate stock and bonds.

We believe that banking organizations can and will bring additional competition to the municipal revenue bond market, and that this will help state and local governments. The issuers agree: every major organization representing state and local governments actively supports bank entry into the municipal revenue bond market. We urge this Committee to make revenue bond legislation a very high priority in this Congress.

ALL REVENUE BOND ISSUES AS A PERCENT OF THE TOTAL LONG-TERM MUNICIPAL MARKET



Source: 1956-65 The Bond Buyer, the only source available for this period.
1966-82 Public Securities Association data base.

Senator GORTON. Thank you, Mr. Patterson.

I thank all the members of the panel. It's been a most interesting panel with testimony forcefully delivered and frequently in disagreement. I'd like to start with one area of disagreement.

The IBAA claims that one of the public policy objectives served by the McFadden Act and the Douglas amendment is the maintenance of a highly competitive system with many providers of banking services competing in almost every market. CBA, however, advocates the ultimate repeal of McFadden and Douglas and the Bank Holding Association recommends permitting holding companies to acquire one another across state lines.

IMPACT OF INCREASED CONCENTRATION

I'd be happy to give each of you that wishes to do so a chance to respond to these differences, perhaps to sharpen these a little bit, but I'd like CBA and the Bank Holding Co. to respond specifically to the IBAA's concern that increased concentration is the likely outcome of changes in those laws and IBAA, in turn, to respond to CBA's belief that the existing restrictions have the practical effect not of increasing competition but of permitting pockets of monopolies and nearmonopolies. Perhaps the ABA, which wasn't quite so forceful on this subject, could comment on both criticisms.

Mr. KENNEDY. Mr. Chairman, we have friends on both sides of the issue.

Senator GORTON. That seemed to be pretty clear.

Mr. HAMMER. Yes, sir. Our position would be that there are so many providers that one just can't look to the traditional providers of the service, that we're going to be shot, the question is who's going to do the shooting?

The evidence on the undue concentration of resources, where it has had an opportunity to accumulate, is very strong. I think the best example with which I am personally familiar, is the rather abortive attempt of the New York City banks when they went upstate after being fought for years by the smaller banks upstate using the same argument.

Well, what's happened? In general the only branches from those efforts that are today profitable are those that were done by acquisition. Virtually all of us who went up there ended up closing most of those branches because we couldn't compete with the local banker.

In addition, concentration itself isn't bad. It's only bad if it's a monopoly and it works in such a way that the consumer is disadvantaged. Now that is not the case. We're not anywhere near the concentration ratio in any of these areas where that's even a viable argument.

Senator GORTON. You say that when you simply tried to move into upstate New York you failed, but you also engaged in acquisitions. That's concentration, isn't it?

Mr. HAMMER. Yes, but the point is, it had no ill effect.

Let me give you an example. We were allowed to do it first by acquisition. That's the way the banks went and then the law was changed. Years later, the de novo approach did not work. In those towns where we were able to go, we were able to provide new services, as a matter of fact the evidence is clear there—every study done by the FDIC with which I was affiliated for a while—indicated the loan ratios went up in those towns. The banks were doing a better job of serving their communities. The relative rates they paid on deposits were also a great deal lower than they are today. So the consumer was beneficiary.

Senator GORTON. Did any of the smaller upstate banks move into New York City after that law?

Mr. HAMMER. Lincoln First did. The New York City consumer was already being served well. There's massive competition in New York City.

Senator GORTON. Mr. Baldwin, do you have anything you wanted to say?

Mr. BALDWIN. Marine Midland did move into New York City.

There are a couple of areas, Mr. Chairman, that I would like to mention. First of all, in the case of California, the Bank of America is the biggest bank in the world yet every single month new banks are being chartered in California.

Increased concentration is not something that's embedded in our charter as something we're striving for, but I'd like to cite first a personal example. Our lead bank in the holding company was roughly a $300 million bank in 1970, when we went into business. Some 20 affiliations later, in 1982, it is now $1.7 billion in assets. This is in Maryland. All the Maryland banks have approximately 1 percent of total the banking deposits—I'm not talking about S&L's or anything else—in the country. And we've labored and groaned all these years and Mercantile now has approximately 9 percent of that 1 percent of the bank deposits in the country after 13 years. And that's my answer to you. I just think concentration is one of the bugaboos that's not a real concern.

Senator GORTON. Mr. Herrington and Mr. McCormick?

Mr. MCCORMICK. Well, I think the way to look at this is to look at the result. There's not any other banking system in the world that has the diverse number of providers of financial services we have in the United States. We have 15,000 banks and the last time I looked at those numbers I don't believe there are more than 500 banks in any other nation in the world. And I think that if you go beyond that and you look in the individual States, those States in which it is alleged that there is less competition because of structural bank laws, in fact I think that the studies by the Federal Reserve make it clear that we have more competition. For example, in Oklahoma there are 500 banks that compete in the marketplace. It is true that there are a few one-bank towns, maybe a county or two where there are only two or three banks, but 90 percent of the people that live in Oklahoma or any other State where we have a highly diverse banking system have many opportunities to do business with locally owned and controlled banks.

In my own market we have 5 banks within 12 miles and so I would say that's a very competitive situation.

Beyond that, I and my association believe it's not a question insufficent of competition. Certainly the New York experience indicates and it's been duplicated in many other States, that the large multibank holding companies, nationwide operations that come in, do not compete effectively because frankly we do a better job in our marketplace than they do.

The issue is acquisition and merger—for example, my bank is $125 million bank and I have the 1,416th largest bank in the country, and banks up to at least $1 billion, maybe $2 billion which encompass more than 90 percent of the banks in the country, have absolutely no protection from tender offers and takeovers and acquisitions and mergers. So if you are going to change McFadden-Douglas or modify it substantially, then you need to look toward coming up with some dramatically different kinds of antitrust rules that are going to regulate acquisitions and mergers or we're going to have a greatly diminished number of banks in the country and I think less competition and service because of it.

Senator GORTON. Mr. Herrington, does that cover it for you?

Mr. HERRINTON. Well, I might say that in our town of Coldwater, Kan. with a population of 1,200 people we have two banks two branches of S&L's, and we've got competition. Kansas has 619 banks and I can imagine if I owned all the banks in my county how we would have more competition there. It's just human nature and I would be a little greedy about it, so to speak. When I've tried to move some farm loans through the city banks, if they feel they can pressure me enough, they would tell me that they want 2 or 3 percent more than I'm charging my customer. We try to keep our loan interest rates down and I was approached by a bank in Wichita that said that they could make a loan to some aircraft plant out there for 19 or 20 percent and I was charging 16 or 17 percent for my farm customers and they said, "What do you think the loan committee would say if I came in with a $100,000 loan for you at 16 percent when I can get 20 percent from some aircraft industry for a loan of maybe $8 or $10 million?" And I'm looking at a measly $100,000. So the competition would certainly not be there if all the banks were controlled by a few companies like that and, needless to say, the human greed is still there, and if I owned all the banks in western Kansas there would be a lot less competition and the consumer would have fewer places to go get a loan and I think it would be very detrimental to small towns as far as the farmer loans are concerned. In turn small businesses in this country employ millions of people and most of these small businesses are financed by small, community banks. If the industry is concentrated they wouldn't be looking to a small business loan when they could go for the larger billion dollar loan or several million loans from big industry. So I think they would be hurting the American people, the people out in the boonies, if they went to a concentration of power like that.

Senator GORTON. Mr. Kennedy, did you want to comment?

Mr. KENNEDY. Mr. Chairman, as I indicated, our position for some time has been to support both McFadden and Douglas. We haven't addressed it in the Government relations field of our organization for some time and I think primarily because the emphasis of our needs has been in a different direction and I'd like to get into that just quickly, but just one other remark that relates to this business of geographic change, and that is that while McFadden and Douglas is firmly in place we are seeing changes in other ways due to States with reciprocal arrangements and other changes of that nature. So the effort is being made by all sorts of institutions to get around the purpose of McFadden and Douglas

The thing I'd like to get back to, though, is the reason we haven't really gotten into it at any great depth in recent months is because our membership has felt like our thrust ought to be on this matter of products and services and our ability to be competitive not so much among ourselves but with these outside people who are pushing at us to take our business away from us. And I think that's where the emphasis ought to be right now.

Senator GORTON. Thank you, Mr. Kennedy.

Senator Hecht.

Senator HECHT. Thank you.

Mr. Kennedy, I would address this to you because you're the chairman and the first speaker and also you're from Pine Bluff, Ark., and I'm from Cape Girardeau, Mo., so we're kind of neighbors.

You mentioned in your statement that you'd like to have some more products and services that you could provide for us. Specifically, who do you have in mind?

DIVERSIFY BANKING INDUSTRY

Mr. KENNEDY. Well, we are taking a look at what's going on out there in the marketplace. We see investment people moving into our business. We see insurance companies moving into our business. We see Sears Roebuck and now J. C. Penney and these other people who are in the process of investigating our business and we feel like we need to have the opportunity to move into things which are financially related.

We recently commissioned a study by Arthur Young & Co., to take a look at 13 different financially related industries such as the securities business, discount brokerage, real estate business and various aspects, insurance business and various aspects, management consulting and things of that type, to tell us where the fields are most profitable and where the banking industry would fit into those fields most profitably.

And I might add, Senator, the first thing you look at is whether it's going to be good for our bank customer and going from there whether it can be profitable. Obviously it's got to be good for the customer or you're not going to make any money out of it.

A direct answer to your question would be that we would like the right—not necessarily to do it—but the right to investigate any business which is related to the financial world. We don't want to go into the shoe business as was alluded to a minute ago. There's nothing realistic about things of that nature. But we would like the right to do the things that other people are doing to us as far as the financial world is concerned.

Senator HECHT. How big is your bank, Mr. Kennedy?

Mr. KENNEDY. It's $180 billion—excuse me—I've been listening to my friend, Mr. Hammer, down there—it's $180 million, sir.

Senator HECHT. Now let's get back and not talk generalities. Specifically, what in your mind would you like to do?

Mr. KENNEDY. I would like to go into the business of underwriting revenue bonds which we do not now have, as Mr. Patterson talked about a few minutes ago. We just recently went into the securities brokerage discount business in our bank in order to meet the competition that we feel is there, and what we would like to do is to be able to generate fee income to offset the rising costs of the funds that we have to pay for in terms of interest on the deposits in the liquid asset account and Super NOW account and other things that are coming along now, and the constant profit squeeze that's coming as a result of our traditional business. We want to stay in that business, but we see the need to broaden our income base by doing such things as I just got through talking about. I would like to study the real estate business as it relates to the banking business and I would like to study the insurance business as it relates to the banking business. I doubt if I would want to go in the insurance underwriting business, but I might want to go into the insurance brokerage business.

Senator HECHT. Now let's discuss the real estate since you brought that up. What services could your bank provide in the real estate business?

Mr. KENNEDY. I think we could run a conventional real estate business as far as that's concerned. We could also go into the equity business. As you know I'm sure the savings and loan associations through service corporations are now in the business of real estate equities and we would like to be competitive with them.

Senator HECHT. Specifically now, what services would your bank provide for let's say a couple who wants to buy a house? What would you do? I'm trying to get it right here rather than generalities. What could your bank do on that basis?

Mr. KENNEDY. I could help them find a home. I could earn a commission off the sale. I don't think it would be deleterious to other people in the real estate business because of the fact that I'm able to finance at the same time. I could provide a service to those people that we're not now able to provide.

Senator HECHT. Now you have a $180 million bank. I can relate to that very well. What type of people are you aiming for? Are you going to advertise? Are you going to start a whole new section of your bank?

Mr. KENNEDY. I might do that, yes, if I thought it was profitable.

Senator HECHT. Let's talk about insurance. What would you do with your bank on insurance?

Mr. KENNEDY. Well, a good many banks across the country are now in the insurance business in towns of 5,000 or less and in some instances in towns larger than that where they've been grandfathered in, and it is a pretty good melding of the two, insurance and the banking industry, from a practical point of view.

Senator HECHT. But most businesses today analyze what their insurance needs are and put it out to several insurance agencies. How could you relate to that because you still have that underlying factor that you could finance?

Mr. KENNEDY. Well, I think what I would do—and understand I would want to do it after considerable thought—I would be privileged right now to make the judgment later on, but what I would do is acquire the degree of competence that you think is necessary and I think I can do that just as good as any other insurance person. In addition to that, there are a great many residential insurance policies, automobile insurance policies that are not directed toward the business world as far as that goes.

Senator **Hecht**. I know, but many of these insurance people spend a lifetime analyzing the life insurance for instance. It's just not one small policy. Let me ask you this. Do you have a trust department?

Mr. **Kennedy**. Absolutely.

Senator **Hecht**. How profitable is that?

Mr. **Kennedy**. It's pretty tough going.

Senator **Hecht**. Why?

Mr. **Kennedy**. Volume and the need for the people to take care of it, to take care of the customers. I think that's historically true of most every trust department.

Senator **Hecht**. Not especially, but this is a banking service that people go to a bank for.

Mr. **Kennedy**. Sure.

Senator **Hecht**. Mr. McCormick, you had your hand up. You want to add something?

INCREASED COMPETITION IN BANKING INDUSTRY

Mr. **McCormick**. Well, I just wanted to comment that what the banking industry is facing is competition that is going to come in and narrow their margins on products that we traditionally offer, for example, the home mortgage; and then try to make up—develop sort of a synergetic system—where they'll make up the profits necessary to function appropriately by offering the insurance on the home, by also offering maybe the title work, maybe even getting into the business of building a home and financing it and providing the insurance. Sears and some other companies are beginning to take those approaches.

Now traditionally, financial services have been separated—and I think for very good reasons because there is enormous potential for conflict of interest. If I'm sitting there offering the insurance sale, brokerage service, I'm offering the mortgage on the house, I'm building the house and I'm a partner with the homebuilder and so on and so on, it's very difficult for me to separate all of my hats there and treat everybody appropriately. But at the same time, since nonregulated providers are doing those things, in order for me to survive, I'm going to have to look at beginning to operate that same way.

So that's the problem that we're talking about is that I'm not going to be able to compete unless I can offer an insurance policy with a mortgage because my competitor is doing that.

Senator **Hecht**. How big is your bank?

Mr. **McCormick**. $130 million.

Senator **Hecht**. OK. Say development came in there too. If a developer would come to you, would you make a 100-percent loan on a development?

Mr. **McCormick**. Now, I won't. It's kind of interesting. It goes both ways. The S&L's can take a piece of the action or be a partner in a development loan. Now there are some developers, particularly those that have a tendency to be undercapitalized, that like that system and would like to have the financial institution as their partner because they get more permissive terms. So there are a group of people that the S&L's have an advantage over the banks in doing business with. On the other hand, there are a group of developers that really don't want to be faced, if you will, with the opportunity of your bank or financial services company asking themselves in as a partner and they prefer to do business with the banks where they're not faced with this participation situation. So it kind of works both ways.

But our view is that if our competitor can do both, we should do both because we're not sure what the competitive marketplace holds out there in the future for us.

Senator HECHT. Let's get back to my question. A developer comes into you and wants to develop. You certainly would want security. You would want the man to have a certain part of it paid for, to have a little bit of his own money in there as equity capital. However, if you go out and develop, that's a 100-percent loan. Now what if the development goes bad?

Mr. MCCORMICK. There are greater risks for a financial institution if they are a partner, not only because they're going to be making probably a more permissive loan but they're taking equity risks and there's no question there would be greater risks for banks. A bank should be compensated for those risks. After all, risks should be a tradeoff with the price you charge and I suspect the banks will do it hoping to achieve much greater profits than they would if they were only the lender and hope that those profits offset the risks that they're taking. To the extent they're able to do that it will work; to the extent they don't, well, then it will be unfortunate.

Senator HECHT. Well, my time has expired, Mr. Kennedy——

Mr. KENNEDY. I just wanted to make one observation. If you did something of that nature it would be in a separate corporation which would be capitalized probably out of a holding company or in the case of the smaller banks out of the bank direct, and if anything should happen, in theory at least, it would not impact the direct any further.

Senator HECHT. My time is up.

Mr. KENNEDY. Maybe I'm glad.

Senator GORTON. Senator Lautenberg.

Senator LAUTENBERG. Thank you, Mr. Chairman.

Mr. Hammer, you said in your remarks that if you're going to be shot it doesn't matter who you're shot by except that if you're shot in the commission of a crime by a police officer it's quite different than if you're shot walking down the street by someone taking your money. The pain may be the same but the result is different.

Mr. Baldwin, you said that there was a relatively small percentage of the marketplace deposit funds, that the commercial bank industry had, if I remember correctly, you said that it had increased only to 9 percent of the total deposit funds. Am I correct?

Mr. BALDWIN. No, sir. In the example I gave you, I was giving our own situation. The question was undue concentration and I said that all the banks in Maryland had approximately 1 percent of the bank deposits in the country. Between 1970 and 1982 our own holding company was involved in some 20 affiliations, and after all that effort we are up to 9 percent of that 1 percent.

The comment I made is that banks have only a part of the deposit business. The commercial banking system is about a third of the total business now; at the end of the Second World War it was maybe two-thirds. It's going down and down.

Senator **Lautenberg**. Yes, because of——

Mr. **Baldwin**. Of these credit unions, S&L, and so forth.

BORROWING OPPORTUNITY COULD BE LOST

Senator **Lautenberg**. Well, also different instruments that are suddenly available to people and they're not necessarily the credit unions and S&L's but the free marketplace money instruments and so forth.

What I'm concerned about generally, gentlemen, is that we're going to leave a large part of our business community and individuals out of the borrowing opportunity because there will be so many more appealing ways to invest one's money in the banking industry and as we talk about expansion of the product line it seems to me rather anomalous that we think that or that it's said that the banks ought to be able to offer more products, but we don't want any of those nonbankers in our banking pocket. Mr. Kennedy described it as "our business," and that suggests something. I hope that you've not considering as one of the things banks ought to be doing is going into the computer business, are you? That's an inside joke if you know my background. It doesn't require an answer.

I sense a thrust throughout the industry that says we want to take care of the need that the banking community services but again we want to do it differently, we want to offer different products. What happens to the individual borrower?

A funny thing, Mr. Herrington. I come from the most populous State in the Union, New Jersey, and we have areas we call the boonies as well. We've got lots of small businessmen and lots of small farmers who depend on the local bank for service and their inability to get that service would be a devastating blow in terms of investment. And despite the fact, Mr. Hammer, I think that you feel that there is more competition out there, I see in the New York experiment I really don't think is the best example because what happened is the large institutions went upstate New York, an area I know very well also, and found out there weren't very fertile fields to plow up there and said to hell with it—forgive me—we're going back to where the good business is and it's unrealistic under any conditions to think that small banks are going to come down to New York City and grab off a part of the market. Marine Midland would be one of the few upstate banks that came down.

I know that all of you are interested in seeing that the banking industry flourishes and grows, but is there question at stake here as to who gets service? Is it the shareholder at the expense of the borrower or the depositor, the small individual? Does that strike you—are these competing parties in any way?

Mr. **Kennedy**. Senator, I don't think so. All of us in this business or whatever business have got to serve the customer or we're not going to be there very long, and I think that's going to maintain—our basic business has always been to provide loan service to the customer, to provide investment service to our community, and I think that's going to continue.

I think the thing that we're concerned about from the standpoint of the industry is that these changes on the liability side of our balance create some long-range problems for us that we're going to have to respond to by generating more income than we feel like we're going to be able to on the loan side of our business. Consequently, that forces us to move into other areas. That's part of it.

The other part of it is all of this market response business that's taking place with Dean Witter and Sears and Prudential and Dreyfuss and the things that you read about moving into our business, and because they're not regulated they're able to do so many more things that are going to be appealing to a customer who can come to Sears and get his tires changed and make a deposit and buy an investment and buy insurance and do all those other things, and that's pretty tough competition to somebody who's as tightly regulated as we are.

Now we don't want to go away from taking care of the loan customer, absolutely not.

Senator **Lautenberg**. But the market conditions suggests and your own testimony says so—that the restructuring that is going on will have an impact. Mr. Herrington's testimony on the same issue or the same area, and that is that you've got to find different ways to make money, to maintain profitability, diversifying into other businesses. This suggests that the plain old banking business as we knew it is not as appealing now because of changing conditions in the marketplace, etc. I'm fearful that the banks will change character to the extent that they become solidly investment companies almost exclusively. That's where the hot money is. That's where the big opportunity is, high velocity. Moving funds along rapidly from place to place, money not standing still long enough to make the loans with suitable maturities to make the long-term mortgage commitments and that kind of thing. And I find myself sometimes arguing in a vacuum here about the fact that there is, I believe, less fixed rate, long-term mortgage money available—and people persuade me, well, that's now up to 50 percent, and I say, no, it's down to 50 percent. It used to be 100 percent.

Should that be of concern to us at all? The fact is that transactions are very expensive to service today. And I know from my previous experience, that where competition becomes unequal is where the larger bank can offer the sophisticated computer service and offer all kinds of broad service while the small bank has to rely typically on its relationship with the ordinary customer to make its livelihood. And, again, I want to be fair with this—I come in with a perspective but not really a bias. I want to be able to do my job as a legislator, but I want to make sure that we're not avoiding our responsibility as a unique industry. I don't see banking, by the way, as just any other industry.

Mr. **Baldwin**. Senator, if I might respond. You said you are concerned that no longer will the fixed rate, long-term mortgage be available, and so on. There's another consumer that we weren't very concerned about for a long, long time and that was the depositor who subsidized the borrower from time immemorial on regulated liability side deposits. Which consumer are we worried about now? The saver who was subsidizing the borrower or the borrower who may now have to pay the market price? And, yes, I think it's very realistic now that the liability side is freed up and the saver is paid compensating market rates for his deposits, yes, it follows that on the asset side you're going to find less long-term fixed-rate loan, And that is a fact.

So when we say which consumer should we be concerned about——

Senator LAUTENBERG. I thank you for your candor, Mr. Baldwin. It's awfully hard to get people to say that. I think we ought to face up to that and maybe there is a different approach to it.

Mr. BALDWIN. The second area that I would like to elaborate a little bit on is the talk about banks wanting to go into all these other services versus their traditional services. We're not saying that. The commercial banking industry has very clearly fixed in its mind what its traditional role is. Namely a lender to individuals, businesses, governments. This is very clear and fixed in our mind. But we have to look no further back than the activities that went on in this room last year when the savings loans had their powers so narrowly defined that a great deal of energy of this committee, your committee, was spent in expanding those powers.

So what we're saying is we're not ignoring our traditional mandate, but we need to be able to deliver a total package so that we won't get trapped as the S&L's were in a narrowly defined band of products which were provided in different ways by others and they got the squeeze put on. So you know last year the efforts in this room was to enlarge their packages of services and we are simply saying let us have a service package, of which lending is, and as far as I can understand and clearly see, will always be the backbone of it. But we've got to be able to deliver a package, along the line Mr. McCormick talked about, starting with the developer maybe making the sale and making the construction loan and maybe having a piece of the action.

Senator LAUTENBERG. Mr. Chairman, if I could extend my time for just one more question, how do you feel—and forgive me if I don't remember your testimony precisely—how do you feel about the nonbank institution, organization, business, coming into the field via the acquisition route.

Mr. BALDWIN. How do I feel about it?

Senator LAUTENBERG. Well, I mean, would you like to see the moratorium?

Mr. BALDWIN. No, sir.

Senator LAUTENBERG. I'm limited in my time, so you'll have to give a short answer.

Mr. BALDWIN. All right, sir. If you will pardon the analogy, this whole talk about moratorium just stirs up images in my mind. The analogy is the bull is loose in a pasture of cows and he's agreeably going about the business that the Lord put the bull on Earth for and suddenly a panel of experts sits around and decides whether it should temporarily make him a steer or not and, more importantly, if we temporarily make him a steer, is he a nonbull bull? And we're talking about the wrong thing.

Senator LAUTENBERG. How would you like to be that cow, Mr. Herrington? [Laughter.] Thank you.

The CHAIRMAN. Thank you, Senator Lautenberg. May I apologize to each of you for not being here at the outset of the hearing. As 2½years as Chairman, this is the first time I've not been here at the beginning of a full committee hearing, but there is one person in town who can call me away and that happens to be the President. As all of you know, we are very much involved in a budget problem and trying to find a solution to that budget is the issue before the Senate this week and I did have to be at a leadership meeting at the White House and I do apologize to you and thank Senator Gorton for taking over in my place.

Senator Heinz.

Senator HEINZ. Mr. Chairman, thank you very much.

First of all, I want to apologize. I, too, wasn't here at the very beginning to hear everything you had to say. My understanding is that as a group you do one of two things: either you want fairly substantial changes in Glass-Steagall or you want your holding companies to be able to do pretty much anything through a separate sub. Is that more or less correct?

Yes; the record will show most heads nodding up and down.

HOW TO MAKE BANKS MORE COMPETITIVE WITHOUT BECOMING NONBANKS

Now I have some questions but I want to just review briefly with you the subject that we really kicked off last year which was part of the Garn-St Germain bill which was how to make banks more competitive without making banks nonbanks.

One of the peculiarities of our legislation, which I think is good legislation which I supported—it may not have gone as far as you all wanted—is that DIDC has been given a variety of authorities and powers. One of those authorities is to create a nonpersonal interest bearing checking account. Now they haven't decided to offer that.

Now I call that a peculiarity because if the intent of Congress was to make it possible for banks to be competitive in that area, I think you all know that were it to authorize such a competitive account it would bear a 12 percent reserve requirement which would be nonearning.

My question to you is, could you conceivably be competitive if such an instrument was created? Does anybody want to answer that?

Mr. MCCORMICK. I guess it is conceivable that we could be competitive since institutions do compete on bases other than price. It would not be possible for us over an extended period of time to price the product competitively with those that are offering the functional equivalent of the same service and receiving interest on the reserves. We would try to do so I'm sure if it was authorized, but we would certainly be competing with one hand tied behind us.

Senator HEINZ. Mr. Hammer, what do you think?

Mr. HAMMER. Well, I think the answer to that question is basically not. While it would be the first step—that's why we've asked in our testiomny for interest on reserves.

Senator HEINZ. Well, I have not discussed this with my colleagues, but as you know, I had legislation in last year, S. 3059 as I recollect, to do that. I will be reintroducing that legislation and hopefully it will become a subject of interest and enthusiasm in the committee. I'm sure it will get interest. Wouldn't you like to have the same?

I'd like to turn to the question of municipal revenue bonds and I suppose I'll address this to Mr. Patterson representing the dealer bankers.

Mr. Patterson, I understand you indicated that the underlying need for banks to get into underwriting municipal revenue bonds is reducing the cost of municipal financing. Senator Garn, having been there, supports that point of view. Would you recommend Congress reduce that cost by other means as well?

Mr. PATTERSON. Through what measures, sir?

Senator HEINZ. Well, for instance, Congress could provide the tax break it now gives only to banks, a deduction for interest paid on funds borrowed to finance municipal revenue bond purchases to all forms of investors.

Mr. PATTERSON. This would be one way of creating a more level playing field and we would have no problems with that.

Senator HEINZ. We could also pay for that expenditure by reducing the percentage of interest banks were allowed to deduct.

Mr. PATTERSON. Well, some move has already been made in that direction through the last Tax Act changes.

Senator HEINZ. But would that not provide in effect a kind of parity?

Mr. PATTERSON. It could. The separately capitalized holding company subsidiary that's been proposed and widely discussed would also create that kind of parity.

Senator HEINZ. Now one of the rationales for the kind of separate but equal—at least that's the intent of the law as we now have it—is where banks such as yours operate under a slightly different umbrella is the safety and soundness requirement, and probably the extent to which we're able to do anything this year is going to be influenced to a considerable degree by perceptions both in Congress and by the general public as to whether banks are indeed safer and sounder today than they were 1 or 2 or 3 years ago.

BANKS IN A STRONGER, SOUNDER, SAFER POSTURE THIS YEAR

I guess my question to you is, in your judgment, are banks in a stronger, sounder, safer posture this year than they were 1 or 2 years ago? Mr. Hammer, do you want to take a crack at that?

Mr. HAMMER. Well, I think to the extent interest rates have come down it allows our borrowing customers a better chance of financing their operations. We feel better about the future than we have over the past several years. To a large extent the banking industry has been experiencing difficulty, of course, due to the fact that our customers have been strangling on the high interest charges that have been forced by rates of our money.

Senator HEINZ. Well, clearly earnings is a part of the picture, but it is not the only part of the picture. Do you believe that the safety and soundness of financial institutions—depository institutions, leaving aside the S&L's which are kind of a special case and not represented here today—is really a substantially brighter picture than it was 1 or 2 years ago?

Mr. HAMMER. Yes. I feel more sanguine about the situation now than I did then.

Senator HEINZ. Does that mean we shouldn't pass the International Monetary Fund $8.4 billion increase authorization that we forwarded out of this committee on Thursday?

Mr. HAMMER. I'm here representing the Consumer Bankers Association and I'm really not prepared to speak for them on that.

Senator HEINZ. Why not? It's very important to the Consumer Bankers Association, is it not?

Mr. HAMMER. Well, basically our charter as an association is to deal with our ability to service the individual consumer.

Senator HEINZ. If the bank isn't around to service the individual consumer because everything is tied up overseas, because somebody has bet the bank in one or two countries, notwithstanding their dedication to the consumers in the United States they serve, aren't some of your members a little active in the international lending?

Mr. HAMMER. Some are, yes, sir. And I think they would feel very strongly——

Senator HEINZ. What bank did you say you worked for in your spare time?

Mr. HAMMER. I think they would feel very strongly and my institution would feel very strongly as I believe Mr. Osborne said before this committee, yes, that bill we would strongly support.

Senator HEINZ. Mr. Kennedy, you had a point to make?

Mr. KENNEDY. Yes, I wanted to comment on that question and then you went a little further afield in the matter of the International Monetary Fund, but basically the banking system is much improved, in good shape. In the first place, the economy is improving and that's going to help. In the second place, the industry as a whole has survived a pretty tough period of time and I think we're leaner and hungrier than we have been in the past and probably from the lessons we've learned are better equipped to face whatever comes.

With relation to the International Monetary Fund, of course, there is a banking issue involved with that question, but I think it's a whole lot broader than that in the sense that we need to be able to continue our trade with these Third World countries. There are a lot of jobs out there in the country both in the agricultural and manufacturing area depending on trade with the Third World countries and for that reason I'm interested in seeing that legislation passed.

Senator HEINZ. Now fundamentally, the way a bank gets into trouble is to make loans to people who are shakey.

Mr. KENNEDY. Not always. Nobody ever made a bad loan to start with.

Senator HEINZ. Nobody ever intended to make a bad loan. It's like that old sign we've seen—"This is a nonprofit business. We didn't intend it that way. That's just the way it turned out."

But my question to you is, have you seen, recognizing that last year was a very tough year not only internationally but for American business firms—have you seen a dramatic improvement in corporate earnings so far?

Mr. **Kennedy**. No, sir; I haven't.

Senator **Heinz**. Then I'm at a loss to really understand why you can all say that banks are in better shape this year than last. If the people who do most of your commercial borrowing are not in substantially better shape today than they were 1 or 2 years ago, how can you make the statement that——

Mr. **Kennedy**. Well, for one thing, you're looking at the results for last year in the figures that you're seeing and I think definitely the interest rate structure has come down and the economy begins to move a little bit and you and your associates up here are going to have a great deal to do with how far we'll be able to go with that when you deal with the budgetary problems that Senator Garn talked about a minute ago, but I think at the end of this year you're going to see some improved results in that area and I'm expressing an opinion at this particular place. I can't prove it at this point.

Senator **Heinz**. Well, my time has expired. I just want to ask this brief question.

Can you more or less assure us that we're not going to have any more Penn Squares or Chase Drysdales or Mexicos or International Harvesters, Continental Illinois kinds of situations over the next year or so?

Mr. **Kennedy**. Absolutely not. I'm just not——

Senator **Heinz**. I forgot to mention the Butcher Bank in that, I suppose.

Mr. **Kennedy**. In the history of our country, there's always going to be situations where you have isolated instances of mismanagement and most of that is what you're talking about.

Senator **Heinz**. Mr. Chairman, thank you.

The **Chairman**. Thank you, Senator Heinz.

PAYMENT OF INTEREST ON STERILE RESERVES

Gentlemen, Senator Heinz was speaking about interest on reserves. I would assume that all of you would favor payment of interest on sterile reserves. I don't know exactly what the climate is now. Back in 1979 before we adopted the Financial Institutions Deregulation and Monetary Control Act in March of 1980, Senator John Tower and I fought that battle here in the committee and we won on a 9-to-6 vote. That's when I really learned that the committee chairman had a little more power than other members of the committee because Senator Proxmire at that time chose not to have another committee meeting after we had at least said in the committee on a 9-to-6 vote that we would have interest on reserves; and then we waited for the House version which did not include that provision to come over from Chairman Reuss; therefore, it was never addressed further. It did not even proceed to the Senate floor.

Unfortunately, regardless of how we all individually feel about the matter of collection of taxes, because of withholding at the source on dividends and interest, the well has sort of been poisoned. Whether it's fair or not, bankers have been placed in a position on that issue that I think makes it less likely for us to consider a lot of things at least for a while. Certainly I would not—and I commend Senator Heinz for the fact that he's going to introduce his bill again and I would certainly support it, as I have always felt that interest should be paid on sterile reserves and it clouded the purpose of the Federal Reserve to be a profitmaking organization. I find no place in their charter or the initial legislation where it was envisioned that they would make over $10 billion a year and return it to the Treasury over and above their own operating expenses, but I don't know that the climate is too good at this time to be able to get through for a number of reasons other than withholding at source. But some of us will continue to try and I hope Senator Heinz will introduce his bill soon, regardless of the climate.

Senator HEINZ. And the Senator would be delighted to have you as a cosponsor.

The CHAIRMAN. Well, I think you would interpret from my remarks that you could probably count on both Senator Tower and I.

Senator HEINZ. I thank my chairman.

RELAXING MCFADDEN BARRIERS

The CHAIRMAN. Mr. McCormick, you stated earlier that the concern you had with relaxing McFadden barriers was primarily acquisitions and mergers. How would you view allowing de novo entry as a first step while still banning mergers and acquisitions?

Mr. MCCORMICK. Well, I think from my point of view for the banking industry it would be a sensible first step. Recognizing that it would create some difficulties on the part of those folks that are in fact at a point where they would like to sell their bank we would want to watch it and make sure that there continues to be as there is now a good solid market for bank sales and bank stock sales while that type of competition is going on.

But I want to say that I think that the studies that have taken place and our experience in our marketplace would indicate that de novo entry by competitors would not be a serious problem.

The CHAIRMAN. So you think it would provide the proper or sufficient buffer for small banks?

Mr. MCCORMICK. We are concerned, though, that if they're going to come in and compete with us that they play by the same rules that we have to play by, particularly in the areas of capital ratios and treatment by regulators and the manner in which they are treated by our insurance fund in regard to problem loans and what have you.

OPINION OF ANTITRUST LAWS

The CHAIRMAN. Last week Chairman Isaac of the FDIC stated that current antitrust laws are inadequate because they focus on narrow geographic and product markets while overall concentrations are not adequately considered. He claimed that the result of such a policy is to have rigid policies with respect to small community bank mergers while at the same time large banks or conglomerates make one major acquisition after another.

Mr. Herrington, would you agree with Chairman Isaac's statement?

Mr. HERRINTON. Yes, sir, I do. I also think McFadden-Douglas and Glass Steagall are being breached by some of these acquisitions and it seems to me that we keep talking about the laws of the land—well, the McFadden-Douglas is the law of the land and I think if we aren't very careful some of these conglomerates that are being put together will get so big that they cannot be allowed to fail or to be broken up. The laws of the land should be enforced.

The CHAIRMAN. Well, they may get big. If they get that big, I'm a little concerned. It used to be, before they split education into a separate department—it may still be—that HEW was the third largest government in the world. Only the United States and the Soviet Union were bigger than HEW. So I hope we don't see concentrations that are bigger than the Government or we are all in deep trouble.

Mr. Baldwin, how do you feel about Chairman Isaac's statement?

Mr. BALDWIN. Mr. Chairman, we tend to forget sometimes the procedure which one now goes through when adding affiliates. A regulatory body—in the case of affiliations it's the Federal Reserve Bank—gives it an anticompetitive test that's quite detailed, and then the Justice Department has another look at it. We sometimes glibly say there is undue concentration. I feel that we are already under very detailed—when one fills in one of those applications for the Fed, it's plenty detailed—regulation. So we feel that concern is very well covered between the current regulator, the Fed, and the Justice Department, right now.

The CHAIRMAN. Therefore, you disagree with Chairman Isaac and say that current antitrust laws are adequate?

Mr. BALDWIN. I think the protection is there. I would agree that there's some inconsistency but there is plenty of protection now and all of us have already felt that.

The CHAIRMAN. Do any others of you wish to make comments?

Mr. HAMMER. I would disagree with Chairman Isaac, sir. I think those antitrust laws have done a remarkable job of protecting every other industry in the country and if you look at the financial services industry, even the largest have a very, very small percentage of total market share. We, for example, are the second largest maker of student loans. We have 3 percent of the market. The largest bank has about 4 percent of the market. Bank of America, in terms of total consumer deposits, is a blip in the eye. This is a huge market, trillions and trillions of dollars. I think we have plenty of protection.

Mr. MCCORMICK. Well, our response to that would be, Mr. Chairman, that the analysis of the present market condition is correct, but we point out the reason why the market is in that condition is because of the present regulations that we have and we remove them at our own peril.

The CHAIRMAN. Any other comments?

Mr. HAMMER. It seems to me that the key point here is that the protection that should be sought is against monopolistic pricing. That was the whole point of those laws originally—not to protect another vendor, but to protect the consumer. And along that dimension in the financial services area, with all the various sources of supply, from all the new vendors coming in.

Mr. **Patterson**. There's a lot more to it than monopolistic practices in pricing. You have concerns about adequate loanable funds in local markets and local industries which have been in my view and in the view of my association very adequately provided by our present banking system. If we change that banking system we don't necessarily know that will be true. Therein lies a very significant concern.

GEOGRAPHIC RESTRICTIONS OUTLIVE USEFULNESS

The **Chairman**. Mr. Herrington, Mr. Hammer's testimony includes the following statement: "Geographic restrictions have outlived their usefulness." I know what your response is, but would you amplify why you feel that they have not?

Mr. **Herrington**. Well, I feel that they have not because I think that I still have faith that the present structure of banking in this country can withstand any kind of problems. Without geographic restrictionsI am concerned about the local community people that we finance, the farms, the small businesses and we make a lot of household loans, education loans for children. I can't believe that a bank like Citibank in New York would be too concerned about the farmer out in western Kansas or in Utah or wherever he might be and they've got a wider scope of what's going on in the world, they get higher rates for their money than we can and I think that the dual banking system should stay intact, that States rights should be upheld, and I think that the McFadden-Douglas legislation doesn't need to be broken down yet.

The **Chairman**. Let me follow up on this and ask you what you think the realities of the marketplace are. As you very well know, I represent a relatively small State, 1½ million people, and I was just shown a list in a banker publication that listed the top 5,000 banks and 14 in Utah are in the top 5,000 in size, and the biggest one is 100th. So I do not represent a State with big banks. Our biggest one is relatively small compared to a lot of those who are far ahead of it.

So as I have always said for many, many years, my bias is against breaking down those barriers. I do not want overconcentration, if for no other reason than if I were just being parochial and representing the financial institutions in my State. I recognize I have a far broader responsibility than that to the entire financial community, but the fact of the matter is we do have grandfathered institutions. First Interstate does operate in my State and 11 other States. Northwest BanCorporation operates in the Midwest. Citicorp is in my State in the form of finance companies. We have interstate trust operations. We have had numerous mergers of troubled institutions, both S&L's and commercial banks over the last few years and there will be more and we have the problem of the so-called nonbank banks. We've got American Express and Shearson. We've got Prudential and Bache. We've got Texaco. We've got all of these things happening which I don't think is understating the problem to say that a revolution is occurring in the financial services industry.

So my biases are just like yours, but how do we respond to what the reality of the marketplace is? Do we continue to say, OK, we're not going to look at McFadden; we will put on blinders and say we want it the way it used to be? That is the dilemma that I face, starting with the same bias, but the reality of the situation is interstate banking is occurring and it is occurring rapidly, and if we are not willing to at least take a look and try and come to some compromise—I don't know if that's regional, I don't know what it is—what happens to the independent banks in my State? That's the question I have in trying to resolve that dilemma from a personal bias to the realities of the marketplace.

Mr. McCormick. Well, I think that our association has very much the same analysis of the marketplace that you do, Mr. Chairman, and it's one of the reasons why our present position is now indicating that we've gone back, we have looked at the results of Douglas and McFadden and we have listed what we think are four very valuable public policy goals that those two laws achieved in the past.

Now we'll acknowledge that there's some question as to whether those laws will achieve the same purposes in the future.

Our position is that before we change those laws we need to devise those methods that are necessary in order to assure that we continue to have the diverse, locally owned and controlled financial system that we presently have.

We're not sure just exactly how to accomplish that, but we would like to work with the Congress to see if we could find ways to assure that we continue to have the kind of system we presently have in our country.

The Chairman. Well, I'm not either, and that is the purpose of these hearings and the process that I've initiated again this year to try and determine. The problem is the marketplace is changing so rapidly that even starting from the same bias, I really wonder how effective the so-called big boys are. I've had Walt Wriston tell me personally several times how notably unsuccessful Citicorp has been in upstate New York when they thought they would go up and capture those markets and the independent bankers have been more competitive and offered a higher level of personal service and Citicorp has not taken their business away from them. Nor, if we look at California, which you cannot ignore California on this committee in any respect, whether it's the realtors, the homebuilders, the bankers, or savings and loans or whatever. There are so many of them in California that you have to think about California sort of separately from the rest of the country.

But as you know, in trying to achieve a do-on-sale compromise, we had worked it out several times until California was finally convinced, but the point of it is, look at Bank of America in California. I don't know of a State where there are more small, independent financial institutions than in California.

So my question is, Is it necessarily true that the big boys, if we remove the geographical restrictions are going to be able to absorb the business? I'm not convinced that they are. I have no desire—and I guess all of you know I'm probably too candid sometimes, but I have no desire to do business with one of the huge banking institutions in this country. I prefer to keep my account with one of the smaller Utah organizations because of the level of personal service that I know I will get even if I were not chairman of the Banking Committee. I assume while I was chairman I would probably get good service from the big ones too, but I will not always be chairman and I will not always be a Senator and I will be back at a small institution where I will be guaranteed that level of personal service.

How do you respond to that reality, that in many cases where these big institutions have been they have not crowded out the small ones?

Mr. BALDWIN. Mr. Chairman, I think the realistic view of the marketplace is evidenced by these gentlemen on my right who keep talking about the smaller communities they serve and the response to the request for loans to the farmers and businessmen. You really answered the question in your description of California.

Regardless of how wealthy the gentleman on my left is from the Chase Manhattan, there is an irreducible number. "The big boys" aren't going to go into every small town and buy up every bank. They can't market competitively, as Walter Wriston said; and second, there simply isn't the capital in the world to buy up every $50 million bank in the country just to be a "bigger boy." So I think your realistic description indicates the marketplace will take care of that. There will always be more modest-sized banks giving you direct, personal service even when you retire as a Senator.

INTERSTATE CONGLOMERATES TAKE OVER BUSINESSES IN OTHER STATES

The CHAIRMAN. Mr. McCormick or Mr. Herrington?

Mr. HERRINGTON. One of the things I was thinking about, Senator, is that all of these interstate conglomerates getting together to take over business in other States—I'd like to read some of their CRA's to see how they reinvest that money in the community like the small banks have to do. You mentioned the deposit taking. That's all you hear, deposit taking. They don't ever say they're going to do something in Utah or where they're going to expand, and I think the CRA should apply to them as equally as they do in small banks. You don't ever hear them say they're making any big loans in Kansas. They just want to take deposits. That's what disturbs me very much.

The CHAIRMAN. That leads me to another area. There is some reservation in your testimony about changes that have occurred and specifically the amount of money flowing into the new accounts mandated in my bill last year. And yet the primary motivation for mandating those new accounts was the fact that the money was being taken out of my State and yours by Merrill Lynch and others and it was not left there for agricultural loans or automobile loans or anything else. I recognize the cost of money is up for that, but I'm a little bit puzzled as to what we would do. I would hate to go back and let the CMA just continue. That wasn't even being considered being reinvested in my State. We had a tremendous battle in the Utah State Legislature over that because, with all due respect to Secretary Regan, Merrill Lynch was not returning that money to my State at all. There's at least a better chance of Chase or Citicorp might make a loan here or there, but there was no chance that money market funds were going to go back and reinvest money for those types of loans.

Mr. McCormick. Mr. Chairman, that is a correct analysis of what took place last year. We were here with the balance of the banking industry saying if you will set us free to compete and bring this money back to our States so that we can loan it to our customers—I think the intent of our testimony is to say that there have been so many changes and so many different things taking place the last couple years, we'd like some breathing room. We'd like an opportunity to stop and digest what's taken place and really develop and understand what it means to our institution before we go on, without intending to be a pitch to go back to the past, because frankly we wouldn't have any idea how to get there.

So we recognize that the world moves on and we move on with it. We're just saying give us breathing room so we can learn what this means to us. We're not really sure what the ultimate financial results of these accounts are going to be. They're changing very rapidly.

The Chairman. Well, I recognize that but I wanted to hear you say it. My difficulty in trying to achieve a balance—I can agree with what you say. We went along for so many years with the marketplace changing rapidly and Congress not responding other than in a very piecemeal fashion. Then when we do something, then the initial response is, hey, we finally have bitten off a pretty big chunk and now let's rest. And I would agree with that philosophy, too, if we weren't faced with so many rapid changes.

In South Dakota, the Delaware situation, and the application for 31 banks in 35 different States and on and on and on. It's daily. There's not a day goes by that somebody doesn't come in and inform me of something happening in the financial services industry that, while legal, is changing the character of the financial services industry.

So how do we balance that? I'm not talking about anything specific, but put yourself on this side and those two competing interests, with the marketplace that is in a revolutionary state, with the technological changes, the computers allowing things to be done that could not have been done before, for the transfer of funds as well as the accounting and keeping track of all that. Yet on changes they say, OK, let's digest what we have already done. If we wait too long to digest that, are we so far behind the power curve that then it takes another big bite? That is the question that I cannot resolve yet myself, but both sides are correct.

Normally my position would be more conservative and say, hey, let's wait and see what happens. If we could hold still—of course, that then leads to talk of some people to have a moratorium and there isn't one of you here who hasn't heard me give a speech about how good Congress was at 90-day extensions, emergency pieces of legislation, and moratoriums. I'm constantly between rocks and hard spots of choices that are not pleasant and Senators who will take all of these different positions creating great confusion on where Congress is going—which is nothing new to the Congress—but how do we resolve that situation, not specifically McFadden, Glass-Steagall or anything else, but the overall thing with our marketplace changing rapidly and dramatically and yet the desire to sit back and take a look and see what's happened?

Mr. KENNEDY. Mr. Chairman, first of all, the public I think likes what has happened very much. I think there's no reason why they wouldn't. They're benefiting from it and I think it would be terribly difficult in the first place to turn back the clock.

On the matter of the payment of interest on commercial accounts which will come up on June, our feeling has been that we ought to go a little slower and see how we come out on the profit picture as far as what has already taken place. I think probably for a time that would be desirable, but I think we're headed in a direction of a free market.

The obvious answer to that lies on the asset side of our balance sheet which we've addressed in some substance this morning with relation to the ability to have products and services on the basis we can compete with these nonbanks and people of that nature and where we can have the opportunity to generate the income which will allow us to continue to be profitable if it happens—and we don't really know yet, but if it happens, we're talking of profit squeeze because of the increasing cost of our funds on the liability side of the balance sheet.

So what we're anxious to do is to push ahead in that direction in order to generate additional income.

Mr. MCCORMICK. Mr. Chairman, the question you pose is a very difficult one, but it seems to me that it would be useful for Congress to go back to the beginning and see if it couldn't appropriately determine what it is that is unique about a bank, what separates what we are doing as bankers from other providers of financial services, and then decide whether we want to continue to separate that institution from other financial services and commerce. What other requirements we are going to lay on a bank that other providers of financial services would not have, what requirements and privileges would a bank have.

Until you go back and revisit that issue and really make those determinations, I do think that we'll have a very difficult time having any idea how to proceed.

The CHAIRMAN. Well, it's just on the issue—obviously we've got to decide what a bank is and redefine that at some point, and I would agree with that. But narrowing it down to Glass-Steagall issues and McFadden—not to Congress—I don't think you're going to find too many people sympathetic getting banks involved in commerce. The issue is much narrower than that at this point. It's talking about financial services in Glass-Steagall and banks underwriting municipal revenue bonds and some of those sorts of things and geographical restrictions.

So even if you define what a bank is, you still have those decisions to make. In the meantime, these people who are not bound by those restrictions, either geographical or some of the Glass-Steagall issues, are going to be running as fast and as hard as they can—and they should. If I were in business, I would be, too—and there is simply no possibility that I see that the battles I've been through the last few years are going the direction of trying to apply restrictions to them. I don't think you could possibly apply geographical restrictions, reserves and so on, and the vote count for that would be so minimal. So again, we can now go to Mr. Hammer, if you could refocus a little narrower on how do we deal with that in the meantime?

S&L'S OWNED AND OPERATED BY COMMERCIAL ENTERPRISES

Mr. McCORMICK. Well, it seems to me that the reason why Congress is not having the opportunity to make a decision in regard to what they want to do with the banking industry in terms of whether it should be appropriately separated from commerce or not, to what extent it should be regulated in regard to concentration and what have you, is going right back to the basic controversy again. You just made the statement that the separation of banking and commerce was something that no one was giving serious consideration of breaching. But in fact, when you have the savings and loan industry which now has bank powers being owned and operated by commercial enterprises, you have a serious breach taking place which is becoming a greater problem every day.

Unless Congress makes a decision in regard to what's going on here, you soon will be in a position where I don't think you will have the opportunity to continue to maintain the separation between banking and commerce because you will have a separate banking system closely wedded to and involved in commerce operating throughout the United States while you all are looking at other issues. So I think it's an issue that has to be addressed.

The CHAIRMAN. What I was referring to is you're correct on one side. On the other side, though, what I was saying is that you're not going to see commercial banks allowed to own an industrial organization, a manufacturing plant, and things of that nature. That is where your prohibitions will come. I don't know of any banks that particularly want to.

You're right that we've got to make that decision, but in the meantime, what I'm trying to get at, suppose we sit back and we do nothing. We say we're going to absorb what has already taken place; we're going to see what the profit picture is, and that takes 2, 3, or 4 years, and that's not a long time around here. Garn-St Germain took 2 years, so you're looking at least that long. Then where are Merrill Lynch, Sears, and Safeway, and so on? Have they gone so far beyond that? Then what type of decisions are we making then? What normally happens is that Congress ends up ratifying rather than channeling what is going on in the marketplace or trying to make some policy decisions. We simply ratify what has already taken place and that certainly isn't good for the small banks of this country.

So it gets back to my basic dilemma of this timeframe. Do we push ahead and try to rationalize it and go ahead and try to come up with a general consensus or do we allow the nonfinancial type institutions or traditional depository institutions just to roll on, because I'll guarantee you they do not want a moratorium? They will back you in what you're saying about let's sit back and see what happens because they will find new ways to be competitive.

What I'm trying to get at is that we usually wait until it's too far gone. Do we study so long that——

Mr. **McCormick**. Mr. Chairman, it's the view of our association that the major thrust of the competitive disadvantage that we have is in the area of product and in this I think we are by and large in agreement with the American Bankers Association. We should not continue to be as restricted in product as we have been in the past because that is the area in which we are having the most difficult time competing with nonbanking providers of financial services, and I would think that we would have an opportunity to reach a consensus, if you will, on that issue and proceed on that ground.

The **Chairman**. Mr. Hammer, you have been very patient.

Mr. **Hammer**. I'm very encouraged by the nature of the questions you asked, Senator, because as we said in our testimony earlier we think you've asked the right ones. What do we do from here on in? We disagree strongly with waiting because for every moment we wait, competitors just go in and take more of our customers and provide more services that we should be providing.

I think basically the answer to that is that we go on some fundamental principles and the key principle among that list would be one of parity, that regardless of how it cuts on a particular issue in terms of product, geographic limitations and compliance, that all providers of financial services—live by the same set of rules. We believe that will allow the customer to reap the greatest benefits.

MARKET CHANGES REQUIRE CHANGES IN LAW

The **Chairman**. As I look back over the nine years that I have sat on this committee and the discussion in general has been basically the same all of these years, but the marketplace—if you look at the difference in the marketplace from when I got here in 1975 and today, and then what we have done in Congress in response to that, it's been minimal, even with those who say Garn-St Germain went too far. It is a minimal response to the change in the marketplace.

So again, I'm torn. My whole emphasis ever since I've been here is to try and achieve some equality and I recognize how difficult it is to define that equality, using that term versus level playing field so you could use another one, and all I see—and the reason I push to make some decisions and not to determine what those decisions should be or what the financial world should be as Jake Garn sees it—that is not the point at all—but try and push people to try and recognize how the market changes so much more rapidly than we change the laws to respond to it.

In general, that is my dilemma and how do we proceed before it's so far down—I mean, that happened in 1980. All of you are very well aware of the Depository Institutions Deregulation Act. Things were going on for several years. In fact they were going on when I first got here and the regulators allowed automatic transfer accounts and share drafts and all that, and then the courts said they couldn't do it. All of you know that story. So essentially that bill was not any great piece of legislation on our part. It simply said this is all going on in the marketplace; it has happened; the regulators allowed it; the courts said they couldn't do it; so we can't unwind it; we can't do that to those poor little credit unions who are geared up for this, so we'd just better ratify it, which is essentially what we did, and that's what I see if we wait too long, that we will be forced into a position that none of us will really like saying that cannot be undone. That is what's happened in the marketplace so we'd better make it legal. And that's why I push, Mr. McCormick—as you know, you and I have been friends for years—why I push not for a specific proposal, but to wake up the financial services industry to the speed of change and try and get Congress not to wait so long that we merely ratify what has already taken place, that we set some policy. I don't mean we dictate policy. The consensus that I've always tried to create, that we bring people together in a general consensus of what ought to be done rather than waiting until it's already fact and then we simply pat everybody on the head and say, continue to do what you have been doing and we have just legalized it for you. That's my whole dilemma and I know I get in trouble with a lot of different groups which say you're moving too fast; you're moving too slow. I don't know what too fast or too slow is except you don't have to be too bright to look at the incredible changes. If somebody had told me 9 years ago what the marketplace would be like today, I wouldn't have believed them. I just simply would not have believed what was going on technologically in the marketplace or that we would be at the point we are today where I could go down and have an ATM at the Safeway store and all that sort of thing.

Mr. Baldwin, do you have a comment?

Mr. **Baldwin**. Yes, Mr. Chairman, if I could. The traditional bank regulatory protections were in the three areas of pricing, geography, and product. Last year in your Garn-St Germain Act, as constructive as it was, it actually addressed only pricing. It was, as you said, something that it took 2 years in the birthing and that was accelerated by the thrift crisis.

The **Chairman**. Not only accelerated, but without the thrift crisis, it probably would not have passed.

Mr. **Baldwin**. The marketplace, as you said several times, is going on out there, which mitigates against the moratorium. What we would hope would be that you take a positive step and would look at all three factors. We can't just look at pricing because that was the past crisis. Geography is part of it, and product is part of it. I think it's critical that we go forward, despite what our instinctive, inherent wishes may be to preserve some status quo, that you look at all three legs of the stool. I don't quite share the enthusiasm of some of my colleagues here in that I think in response to Senator Heinz' question of how is our industry doing—leave aside the S&Ls, how is your industry? Well, we can't leave aside the S&Ls. We can't leave aside the other depository institutions.

I, for one, think that we're probably only 300 basis points away from another crisis in those industries if interest rates went up. So it's a temporary solution. We must act now and the marketplace doesn't allow us any other luxury and doesn't allow us time for any emotional meanderings because we don't have time.

The **Chairman**. You know, it's interesting that a lot of people would support a moratorium and yet the same people that support a general moratorium—and there is a parade of calls or people dropping in every day for their organization to be exempted from a moratorium, as long as you place it on everybody else. So if we gave everybody and exemption, we'd have a moratorium with nobody being controlled by it.

Mr. McCormick. The thing that's so troublesome about the line of the dialog that's going on with us is to take, for example, the nonbank bank or the loophole in the Bank Holding Company Act. That doesn't seems to me to be an appropriate market activity and the idea that the regulators and the financial institutions will find novel approaches to break down deregulation in order to do something that Congress has previously determined that they did not want them to do, it doesn't seem to me is appropriate competition. If we wanted to go through this little routine of pretending a bank is not a bank because you take away one of its functions and then say it's no longer subject to the Bank Holding Company Act, if Congress really wants that to take place they should take action and authorize it.

I don't think Congress wanted it to take place and I don't think that it's a God-given right of the free market, if you will, to find novel ways to break down the intent of Congress. That would be our view of the loophole.

The Chairman. It may not be a God-given right, but it will continue in this industry and every other industry, and I suppose, even though I may not agree with some of the actions, I would hate to cut off the innovative thinking of the American business community in trying to find ways around it. I don't want you to misunderstand that statement. Good heavens, if they didn't, it would be a very sterile economy. That doesn't mean I agree. I think the definition is a little bit ridiculous where you can just offer commercial accounts and so on and so it isn't a bank. I would agree with you. But as long as the law is that way, I'm not going to condemn somebody for doing it. You're right. We ought to change the law and make that definition whatever we think it should be.

Gentlemen, I appreciate you being here. Thank you very much.

The committee is adjourned.

[Whereupon, at 11:55 a.m., the hearing was adjourned.]

FINANCIAL SERVICES INDUSTRY—OVERSIGHT

Part I

WEDNESDAY, MAY 4, 1983

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, D.C.

The committee met at 10 a.m. in room 538, Dirksen Senate Office Building, Senator Jake Garn (chairman of the committee) presiding.

Present: Senators Garn, Hecht and Lautenberg.

OPENING STATEMENT OF CHAIRMAN GARN

The CHAIRMAN. The Banking Committee will come to order.

Today we continue oversight hearings on the conditions in the financial services industry. This is the fifth day of hearings and we have had Secretary Regan, the regulators, association witnesses yesterday, and we are certainly happy to continue the association witnesses today.

With what is happening in the marketplace, the rapid revolutionary changes that are going on, I certainly, as I've said many times before in these hearings, feel it is necessary to gather all the information we can from all different viewpoints on what direction we may wish to go with McFadden and Douglas and the Bank Holding Company Act as well as the Glass-Steagall.

So we're happy to welcome each of you here today. The first panel is composed of William B. O'Connell, president, U.S. League of Savings Institutions, Chicago; Frank L. Coffman, Jr., president, First Federal Savings and Loan Association, Harrison, Ark., president of the National Savings and Loan League; Herbert W. Gray, Chairman, Mutual Bank for Savings, Boston, Mass., chairman, National Association of Mutual Savings Banks; and William B. Muse, Jr., president, Imperial Savings and Loan Association, Martinsville, Va., member, board of directors, American Savings and Loan League.

Gentlemen, we're happy to have you with us this morning. Mr. O'Connell, if you would like to begin.

STATEMENT OF WILLIAM B. O'CONNELL, PRESIDENT, U.S. LEAGUE OF SAVINGS INSTITUTIONS, CHICAGO, ILL.

Mr. O'CONNELL. Thank you, Senator. My name is William B. O'Connell, and I'm president of the U.S. League of Savings Institutions.

You and your committee are to be congratulated, Mr. Chairman, for undertaking the challenge of this review of our nation's financial services system.

The marketplace today is characterized by innovation and intense competition. These forces require constant observation and, when appropriate, occasional correction if we are to insure that the investment and credit needs of all American communities, the small as well as the large, are to be met.

Delicate balances are involved here, balances which are best approached from a single unified perspective. I do not exaggerate when I say that the future economic health of this Nation hangs on the wisdom of your actions.

We have seen our financial system out of balance on more than one occasion in recent years. One such imbalance, in recent years, for example was caused by the massive diversion of funds from depository institutions to the money market mutual funds. Today we see being raised yet another question of balance, the nonbank bank issue.

Chairman Volcker of the Federal Reserve perceives the acquisition of depository institutions by nonbank entities to be cause for concern, and he would impose a strict legislative moratorium on such combinations. The Comptroller of the Currency already has imposed a regulatory moratorium on new nonbank charters.

The purpose behind their actions and recommendations has been to afford the Congress time to investigate the impact of such combinations on our financial services system and to develop new public policies to insure balance, safety and soundness.

TIGHTENING THE BANK HOLDING COMPANY ACT

The implication is one of a tightening of the Bank Holding Company Act to strictly limit the entry of nonbank entities into the banking field. Those who would pursue that course now speak of rationalizing the Savings and Loan Holding Company Act which, if done, would be to reject as unsound the public policy adopted by the Congress in 1966 and reaffirmed as recently as 6 months ago through enactment of the Garn-St Germain Act.

As you are well aware, our institutions are required by law and regulation to meet certain asset composition tests. So long as those tests are met under the Savings and Loan Holding Company Act, savings institutions may be and indeed are owned by companies whose principal businesses are distinctly different fom that of deposit-taking and providing credit. The authority for unitary savings and loan companies is of tremendous value in bringing capital into our business and there has been no greater example of that value than in the troubled years of 1981 and 1982.

In our view, changes in the Savings and Loan Holding Company Act are not justified at this time. If changes are to be made, they should be considered in the Bank Holding Company Act to bring it more into conformity with our own. This we would not oppose, provided that the two industries remain separated.

Our policymaking machinery has under intensive review at the present time the wisdom of broad-scale entry into the savings and loan business of national investment banking and brokerage firms.

We are concerned that such financial giants may view acquisition of a small savings and loan charter as an avenue to acquire FSLIC insurance accounts for the investment products offered to their Wall Street customers. Extensive use of such a device by a brokerage house with a nationwide sales force would greatly enlarge the risk exposure of the FSLIC fund. It is also unclear to what extent the funds channeled through the captive depository would accomplish the fulfillment of local credit needs for homes and other goods and services for which thrift institutions are traditionally chartered.

I would also note that one distinction drawn in Chairman Volcker's request for a moratorium, an exception for acquisitions which would accomplish supervisory mergers, is hardly an answer to the general problem. Pending applications at the Federal Home Loan Bank Board clearly demonstrate that brokerage firms are willing to pay substantial sums for savings and loan charters, whether or not the target is a matter of supervisory concern.

If it is your view that public policy needs to be revised or restated in this regard, it would be our hope that the focus be restricted, and not be so broad as to contemplate denying savings institutions their longstanding access to new capital from business and commercial entities outside the financial services area.

Savings and loan associations are not subject to the strictures of the McFadden Act prohibition against commercial bank branching across State lines—a fact, I might say, that in recent years has played a big role in the protection of the assets of the FSLIC. The FSLIC and the Bank Board were creative in their approach to finding healthy partners for institutions weakened by high interest rates, and that creativity would have been stifled had they not been able to search out of State for solutions.

Again, this supervisory thrift acquisition question was addressed last year in the Garn-St Germain Act and we believe that the interstate/interindustry acquisition procedure set forth in that act is an appropriate one.

Furthermore, where the rescuer is a bank or bank holding company, Section 408(m)(5)(c) imposes a McFadden pattern on the acquired thrift which fails to maintain its thrift characteristics under tax code standards.

PROPOSAL OF RISK-RELATED INSURANCE PREMIUMS

The Federal Home Loan Bank Board has recently conducted a study aimed at the possible revision of the insurance premium structure of the FSLIC. A proposal has been advanced which would impose a system of risk-related insurance premiums. The problem is that no one has yet devised a means whereby a completely mechanical risk measurement system can be used to assess variable premiums.

We have opposed that proposal on these and on other grounds. This is an extremely complex issue. It would be our recommendation that the Congress provide adequate time for an evaluation of the performance of savings institutions in the Garn-St Germain environment before considering any proposals which would change the existing insurance premium structure.

We would apply similar arguments in opposition to any proposal for the consolidation of the FSLIC with the FDIC and the National Credit Union Share Insurance Fund. While it would appear at first glance that these funds are similar in that each insures deposits, they are dissimilar in many regards. Most important among these is the varying level of risk inherent with each class of member institutions, risk that is based, of course, on the various forms of investment activities permitted to these very distinct institutions. It would seem to make little sense, therefore, to consolidate them into a single monolithic fund.

CONSOLIDATION OF EXISTING REGULATORY AGENCIES

Once again we have heard it suggested that the Federal financial institution regulatory functions could be vastly improved through the consolidation of the existing regulatory agencies in whole or in part. Whereas the regulation of the commercial banking business is a responsibility distributed among three separate agencies—the Federal Reserve Board, the Comptroller of the Currency, and the FDIC—savings and loan institutions have but a single regulator, the Federal Home Loan Bank Board, which exercises each of the regulatory functions which the commercial bank regulators perform for their constituencies.

With that in mind, it may be worthwhile to consider the possibility of consolidating the commercial banking regulatory functions. In the case of savings institutions, that consolidation is already in place within the Bank Board and it should serve as a model for realistic improvements in the commercial banking regulatory system.

The operational authorities of savings institutions as prescribed by the tax and financial institutions laws continue to place our institutions in the category of specialists. While our investment authority has been diversified somewhat, it has not been broadened to the extent that we are the mirror image of our commercial bank cousins. If that day is in the future, in our judgment, it is in the far distant future. It is certainly not the case today. Indeed, it was only last week that the Federal Home Loan Bank Board issued final regulations covering the new authorities contained in the Garn-St Germain act. Even with these finally in hand, there is little question in my mind that the vast majority of savings institutions will continue in the business that they know best, that of residential mortgage lending.

While the Garn-St Germain act contains much of significance to our institutions, there remain numerous other needs which we hope this committee will address in any comprehensive legislation the committee might produce. I would begin with the monopoly which commercial banks have had since the 1930's on business demand deposit accounts.

Deregulation, as you well know, of savings accounts ceilings is progressing rapidly and will be completed long before the March 1986 deadline set in the Depository Institutions Deregulation and Monetary Control Act of 1980. When that occurs, savings institutions and commercial banks will be competing on an equal footing for savings deposits. Some of these deposit accounts carry an unlimited degree of transactionability. At the point when this great deregulation is completed, savings institutions will be at a severe disadvantage, lacking as we do now the authority to offer unrestricted NOW or checking accounts. We believe the committee would be justified for reasons of competitive equality to authorize such accounts for savings institutions so that we might better serve our business and commercial communities. At the very least, we would urge the committee to authorize the offering by savings institutions of corporate NOW accounts and demand accounts to all who seek them.

Our written statement which you have before you covers numerous other areas which we believe should be addressed and we ask that this committee give these areas full consideration.

[Complete statement follows:]

Testimony of
WILLIAM B. O'CONNELL, President
U.S. League of Savings Institutions

before

COMMITTEE ON BANKING, HOUSING & URBAN AFFAIRS
United State Senate
Washington, D. C.
May 4, 1983

Thank you, Mr. Chairman, and members of this distinguished committee, for this opportunity to appear before you today as the representative of the U.S. League of Savings Institutions.* My name is William B. O'Connell, and I am President of the U.S. League, which is the principal trade organization representing this nation's savings institutions, including savings and loan associations and savings banks.

I am advised that at one point during last week's Committee hearings, Mr. Chairman, you commented that last year's Garn-St Germain Act -- comprehensive and reforming as it was

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*The U.S. League of Savings Institutions, formerly the U.S. League of Savings Associations, has a membership of 3,800 companies representing over 99% of the assets of the $700 billion savings and loan business. League membership includes all types of associations -- Federal and state-chartered, stock and mutual. Many prominent savings banks belong as associate members. The principal officers are: Leonard Shane, Chairman, Huntington Beach, Calif.; Paul Prior, Vice Chairman, New Castle, Indiana; William O'Connell, President, Chicago, Illinois; Stuart Davis, Legislative Chairman, Beverly Hills, Calif.; Roy Green, Director-Washington Operations; Phil Gasteyer, Legislative Counsel; James Freeman, Senior Legislative Representative. League headquarters are at 111 East Wacker Drive, Chicago, IL 60601. The Washington Office is located at 1709 New York Avenue, N.W., Washington, D.C. 20006. Telephone: (202) 637-8900.

-- merely scratched the surface in terms of structuring this nation's financial services industry to meet the demands of a rapidly changing marketplace. We are appreciative, of course, of the opportunities for survival and revival which savings institutions were provided in the Garn-St Germain Act; it was an appropriate and sorely needed legislative response at a time of severe economic stress, not only within our business, but throughout the general economy. Having said that, I must also say that I agree with your implied assessment last week, Mr. Chairman: that much remains to be done in the evaluation of our depository institutions and the related financial services businesses.

The question you have undertaken to answer through this series of oversight hearings is how that might best be accomplished. That is not an easy question to answer. Delicate balances are involved here -- balances which are best approached from a single, unified perspective. I do not exaggerate when I say that the future economic health of this nation hangs on the wisdom of your actions.

We have seen our system out of balance -- or what we have come to regard as proper balance, based upon the banking reforms of the 1930s -- on more than one occasion in recent years. Money market mutual funds are an excellent example of how innovative minds in the financial services sector produced a device for circumventing restrictions on deposit interest rates which constrained traditional depositories. As a result, we saw massive disintermediation from commercial banks, savings and loan associations, savings banks and credit unions -- disintermediation to a hybrid creature unable to meet anything but the shortest term credit needs of the marketplace. Money market mutual funds, spurred by high interest rates and inflation, rapidly became the favorite savings vehicle of the American public. The result was a serious, negative impact on the availability of affordable credit for any borrower -- consumers and businessmen alike.

This imbalance was corrected, of course, with the enactment of the Garn-St Germain Act, one provision of which was to authorize depositories to offer transactionable, market-rate savings accounts. Since the introduction of these accounts four months ago, savings are returning to our institutions and we read weekly of outflows from the money market mutual funds. But until the start of this year, the hometown savings/hometown credit link on which home builders, small businessmen, retailers, automobile dealers and consumers had come to rely, was in danger of being severed because lendable funds were leaving the community for the money centers and on to international banking.

Today we see being raised yet another question of balance -- the "non-bank bank" issue. Chairman Volcker of the Federal Reserve perceives the acquisition of depository institutions by non-bank entities to be cause for concern, and he would impose a strict, legislated moratorium on such combinations. The Comptroller of the Currency already has imposed a regulatory moratorium on new, non-bank charters. The purpose behind their actions and recommendations has been to afford the Congress time to investigate the impact of such combinations on our financial services system, and to develop new public policies to ensure balance, safety and soundness. The implication is one of a tightening of the Bank Holding Company Act to strictly limit the entry of non-bank entities into the banking field.

Those who would pursue that course now speak of "rationalizing" the Savings and Loan Holding Company Act with the Bank Holding Company Act which, if done, would be to reject as unsound a public policy adopted by the Congress in 1966 and reaffirmed as recently as six months ago through enactment of the Garn-St Germain Act. As you are well aware, our institutions are required by law and regulation to meet certain asset composition tests. So long as those tests are met, under the Savings and Loan Holding Company Act, savings institutions may be, and indeed are, owned by companies whose principal businesses are distinctly different from that of deposit-taking and providing credit. The authority for unitary savings and loan holding companies is of tremendous value in bringing capital into our business, and there has been no greater example of that value than in the troubled years of 1981 and 1982.

There are very distinct and unique safeguards in the Savings & Loan Holding Company Act. Unlike the Bank Holding Company Act, the Savings and Loan Holding Company Act requires that a holding company with debt in excess of 15% of consolidated net worth cannot issue further debt without the prior written approval of the FSLIC. In addition, a savings and loan holding company's insured subsidiary institution cannot invest in the stock or debt of the holding company or an affiliate, accept any stock or debt as collateral for loans to an affiliate, guarantee repayment of holding company debt, or maintain a compensating balance for any affiliate or the holding company.

In our view, changes in the Savings and Loan Holding Company Act are not justified at this time. If changes are to be made, they should be considered in the Bank Holding Company Act to bring it more into conformity with our own. This we would not oppose -- provided that the two industries remain separated.

We would encourage the Committee to proceed cautiously in response to requests for a wholesale rewrite of the activities tests found in Section 4(c)(8) of the Bank Holding Company Act, which limits activities to those which are "closely related to banking and properly incident thereto." Depositories perform a vital function as local intermediaries for acquiring funds and providing credit to the American people; replacing the 4(c)(8) test with authority to engage in anything of a "financial nature" could dilute the effectiveness of the depositories' role, while opening the door to much greater consolidation of the financial community.

Our policy-making machinery has under intensive review at the present time the wisdom of broad-scale entry into the savings and loan business of national investment banking and brokerage firms. We are concerned that such financial giants may view acquisition of a small saving and loan charter as an avenue to acquire FSLIC insurance of accounts for the investment products offered to their Wall Street customers. Extensive use of such a device by a brokerage house with a nationwide sales force could greatly enlarge the risk exposure of the FSLIC fund. It is also unclear to what extent the funds channeled through the captive depository would accomplish the fulfillment of local credit needs "for homes and other goods and services" for which thrifts are traditionally chartered.

I would also note that one distinction drawn in Chairman Volcker's request for a moratorium -- an exception for acquistions which accomplish supervisory purposes -- is hardly an answer to the general problem. Pending applications at the Federal Home Loan Bank Board clearly demonstrate that brokerage houses are willing to bid substantial sums for savings and loan charters, whether or not the target is a matter of supervisory concern. If it is your view that public policy needs to be revised or restated in this regard, it would be our hope that the focus be restricted, and not be so broad as to comtemplate denying savings institutions their long-standing access to new capital from business and commercial entities outside the financial services area.

THE GLASS-STEAGALL ACT

Another area of current controversy also derives from the commercial banking sector, rather than the savings and loan community, and that has to do with applicability of the Glass-Steagall Act. Savings institutions, through their service corporations, are permitted to take orders for stock purchases. To the extent to which they have been undertaken, the Federal Home Loan Bank Board has determined that these activities are not in violation of Glass-Steagall. While the involvement of our institutions' subsidiaries in this area of financial services is in its infancy, there is every reason to believe that it is pro-competitive, that it contributes to the health of the savings industry, and that it responds to the needs of the marketplace.

THE McFADDEN ACT

Savings and loan associations are not subject to the strictures of the McFadden Act prohibition against commercial bank branching across state lines -- a fact that in recent years played a large role in the protection of the assets of the Federal Savings and Loan Insurance Corporation. The FSLIC and the Bank Board were creative in their approach to finding healthy partners for institutions weakened by high interest rates, and that creativity would have been stifled had they not been able to search out-of-state for solutions.

Again, this supervisory thrift acquisition question was addressed last year in the Garn-St Germain Act, and we believe that the interstate/inter-industry acquisition procedure set out in the Act is an appropriate one. Furthermore, where the rescuer is a bank or bank holding company, Section 408(m)(5)(C) imposes the McFadden pattern on an acquired thrift which fails to maintain its thrift characteristics (under tax code standards).

ROLE OF DEPOSIT INSURANCE

It is impossible to overemphasize the importance of the deposit insurance function. We have experienced decades of financial institutions stability since the 1930s, and without question this can be traced directly to Federal deposit insurance. It is troubling to ponder what course our institutions might have taken over the past two or three years had the public not had the confidence which Federal deposit insurance provides.

In accordance with Section 712 of the Garn-St Germain Act, the Federal Home Loan Bank Board has conducted a study aimed at the possible revision of the insurance premium structure of the FSLIC. A proposal has been advanced which would impose a system of risk-related insurance premiums. The problem is that no one has devised a means whereby a completely mechanical risk measurement system can be used to assess variable premiums.

We have opposed the proposal advanced by the Bank Board on these and other grounds. This is an extremely complex issue, based on a desire to ensure the adequacy of the FSLIC while at the same time providing financial incentives to management to limit the assumption of additional risk. It would be our recommendation that the Congress provide adequate time for an evaluation of the performance of savings institutions in the Garn-St Germain environment before considering any proposals which would change the existing insurance premium structure.

We would apply similar arguments in opposition to any proposal for the consolidation of the FSLIC with the Federal Deposit Insurance Corporation and the National Credit Union Share Insurance Fund. While it would appear that these funds are similar in that they each insure deposits, they are dissimilar in many regards. Most important among these is the varying level of risk inherent with each class of member institutions -- risk that is based, of course, on the various forms of investment activities permitted those very distinct institutions. It would seem to make little sense, therefore, to consolidate them into a single, monolithic fund.

REGULATORY AGENCY CONSOLIDATION

Once again we have heard it suggested that the Federal financial institutions regulatory functions could be vastly improved through the consolidation of the existing regulators, in whole or in part. This is a suggestion which, in my view, becomes more impractical with each step we take along the path to further deregulation of the financial services industry. There is no way that we can adequately suggest a new regulatory structure until we know precisely what it is that needs to be regulated. With deregulation occurring so rapidly, we have virtually no history of the impact of that deregulation to guide us.

Whereas the regulation of commercial banks is a responsibility distributed among three separate agencies -- the Federal Reserve Board, the Comptroller of the Currency and the Federal Deposit Insurance Corporation -- savings and loan institutions have but a single regulator -- The Federal Home Loan Bank Board -- which exercises each of the regulatory functions which the commercial banking regulators perform for their constituencies. With that in mind, it may well be worthwhile to consider the possibilities of consolidating the commercial banking regulatory functions. In the case of savings institutions, that consolidation already is in place in the Bank Board and it should serve as model for realistic improvements in the commercial banking regulatory system.

Chairman Volcker, in his recent appearance before you, stated that thrift institutions have essentially become bank-like institutions. For some, this would constitute justification for the consolidation of all regulatory agencies -- if it were true. It is not true, either on paper or in reality.

The operational authorities of savings institutions, as prescribed by the tax and financial institution laws, continue to place our institutions in the category of specialists. While our investment authority has been diversified somewhat by the Garn-St Germain Act, it has not been broadened to the extent that we are the mirror image of our commercial cousins. If that day is in the future, it is in the far distant future. It is certainly not the case today, since our institutions have only had their expanded powers in place since October. Indeed, it was only just last week that the Federal Home Loan Bank Board issued final regulations covering the new authorities contained in the Garn-St Germain Act. Even with these finally in hand, there is little question in my mind that the vast majority of savings institutions will continue in the business that they know best -- that of residential mortgage lending.

CONTINUING NEEDS OF THE INDUSTRY.

While the Garn-St Germain Act contained much of significance to our institutions, there remain numerous other needs which we hope this Committee will address in any comprehensive legislation you might produce. I would begin with the monopoly which commercial banks have had since the 1930s on business demand deposit accounts.

Deregulation of savings account ceilings is progressing rapidly, and will be completed long before the March 1986 deadline set in the Depository Institutions Deregulation and Monetary Control Act of 1980. When that occurs, savings institutions and commercial banks will be competing on an equal footing for savings deposits, with some of those deposit accounts carrying a limited degree of transactionability. At the point when this rate deregulation is completed, savings institutions will be at a severe disadvantage, lacking as we do the authority to offer unrestricted NOW or checking accounts. We believe the Committee would be justified for reasons of competitive equality to authorize such accounts for savings institutions, so that we might better serve our business and commercial communities. Certainly, it makes no sense to preserve the fiction that checking accounts may not pay interest -- a statutory legacy now almost a half century old. At the very least, we would urge the Committee to authorize the offering by savings institutions of corporate NOW accounts, or demand accounts to all who would seek them, rather than only to those with whom they have loan relationships as is presently the case.

In the area of our service corporation subsidiaries, we believe the 3% investment limitation should be increased, and would oppose efforts to restrict by statute the Bank Board's flexibility to approve new activities for these subsidiaries.

We believe the Bank Board should have some discretion to permit Federal savings institutions to utilize the rights and powers available to state-chartered institutions in states where those Federally-chartered institutions have their home offices and competitive imbalances develop.

Attention should be paid to amending the Home Owners' Loan Act of 1933 to authorize Federally-chartered savings institutions to joint venture with third parties to facilitate the sale of low-yielding loans, to provide for general "prudent man" investment authority to a limited percentage of assets, and to authorize improvement loans on non-residential real estate without a percentage-of-assets limitation.

We would oppose any legislative restrictions on the insurance activities of FSLIC-insured institutions' service corporations or holding company subsidiaries. As well, we would oppose efforts to restrict referrals of borrowers to subsidiaries providing title or private mortgage insurance or escrow services.

We believe that if Congress chooses to extend securities powers or opportunities to banks and bank holding companies to directly operate, sponsor and broker mutual funds, and to underwrite revenue bonds they should be extended as well to savings institutions, their service corporations and their holding companies or holding company subsidiaries.

We find the "anti-tying" language in Section 331 of the Garn-St Germain Act to be duplicative of other anti-trust laws and Bank Board regulations, and believe it should be repealed or amended to give the Bank Board discretion in applying the statute, as is currently the case with the Federal Reserve and commercial banks.

Adjustable rate mortgages are vital to our continued health as residential mortgage specialists operating in changeable economic climates and we would urge the Committee to do all in its power to assist in promoting their use.

In the area of accounts insurance, we again urge you to authorize full, 100% FSLIC and FDIC coverage for the deposits of Federal, State and local governments entities, as well as full 100% coverage of Individual Retirement and Keogh Accounts and other trusteed benefit retirement plans.

Universal reserves requirements should be removed on accounts other than transaction accounts; they should be imposed on money market fund balances with transaction account features.

Residential real estate loans should be excluded from the Truth-in-Lending law. This requirement is burdensome and costly to institutions, and of little demonstrable value to home buyers. The Committee appeared to confirm this appraisal last year when it excluded realtors from Truth-in-Lending requirements, despite their growing involvement as arrangers of credit through so-called creative financing.

And finally, though we realize it is not within the jurisdiction of this Committee, we would urge that the definition test for maximum use of the bad debt and other deductions found in Section 593 of the Internal Revenue Code be revised. The qualifying assets should be broadened to include commercial real estate loans and the qualifying percentage should be lowered to 72% (the mutual savings bank standard) from 82% (the savings and loan test). Under Garn-St Germain, savings banks and savings and loans are virtually indistinguishable -- yet the tax laws impose a different definitional standard. The change would remove, as well, an artificial barrier to greater asset diversification by thrifts -- an underlying purpose of the Garn-St Germain Act.

CONCLUSION

The Garn-St Germain Act has had far-reaching implications for our institutions. The Money Market Deposit Account and the Super NOW account are revolutionizing our core deposit base. These combination savings/transaction accounts carry high rates, short terms and are extremely liquid. Their existance demands flexibility on the asset side of the ledger, and we must be ever vigilant to that. We must not think in terms of unduly restricting the savings institutions manager within the marketplace; we must be ever aware of the manager's need for additional prudent investment vehicles for his depositors' funds. We must be cognizant of funds-acquisition costs and look diligently for means to reduce them. We must not impair the availability of new capital for his business, but rather seek to identify new sources of it consistent with the role performed by depositories in our financial system.

We have scratched the surface of deregulation through enactment of the Garn-St Germain Act, Mr. Chairman, and what we have found beneath it is the promise of future good health for savings institutions in an era of financial services revolution. We trust that this Committee in its wisdom will proceed with the deregulation process with all due regard to timing, balance, and equality of competitive opportunity.

You and your Committee are to be congratulated, Mr. Chairman, for undertaking the challenge of this much-needed review of our nation's financial services system. The marketplace today is rife with innovation bred by fervid competition. These forces require constant observation and, when appropriate, occasional correction if we are to ensure that the investment and credit needs of all American communities -- the small as well as the large -- are to be met.

Thank you for the opportunity to appear before you today. I look forward to your questions.

The **Chairman**. Thank you, Mr. O'Connell.

I would say to each of you that your entire statements will be printed in the record in full.

Mr. Coffman.

STATEMENT OF FRANK L. COFFMAN, JR., PRESIDENT, FIRST FEDERAL SAVINGS & LOAN ASSOCIATION, HARRISON, ARK.; PRESIDENT, NATIONAL SAVINGS & LOAN LEAGUE

[Complete statement follows:]

Statement By
FRANK L. COFFMAN, JR.

Mr. Chairman, members of the Committee, my name is Frank Coffman and I am the President of First Federal Savings and Loan Association of Harrison, Arkansas. I have the privilege of appearing before you today as the President of the National Savings and Loan League. On behalf of the officers and members of the National League I want to compliment the Chairman for convening these hearings on the condition and future of the nation's financial services delivery system. We recall that similar hearings were held in this room two years ago, at the beginning of the 97th Congress. I think it is safe to say that those hearings were the necessary first step toward the enactment of the most important financial institutions legislation in fifty years--the Garn-St Germain Depository Institutions Act of 1982.

Before commenting on the issues which lie ahead of us, I want to take this opportunity to express our appreciation to this Committee and especially to Chairman Garn for making the commitment necessary to achieve the enactment of the Garn-St Germain Act. We know that balancing all of the competing and conflicting points of view was a difficult task. I can say without reservation that your efforts are deeply appreciated and will prove worthwhile.

As significant as the 1982 Act is, however, it is only a first step toward rationalizing the legal and regulatory framework of depository institutions with the marketplace realities which exist today. The pace of change and innovation in the delivery of financial services will not, in our view, be abated in the foreseeable future. Innovations made possible by technological breakthroughs and driven by long-range profit motive will continue to develop and exploit inconsistencies and weaknesses in the basic fabric of banking laws enacted when a home computer existed only in a Buck Rogers movie. Laws restricting product lines and geographic markets are increasingly less and less relevant to the real world of our financial marketplace.

We sincerely hope that, with these hearings, the momentum begun with the Garn-St Germain Act will be maintained. We know that the changes we advocate are controversial and will take time. We hope that each year will bring yet another positive step.

Treasury Proposal on Holding Company Activities

The National League membership has considered the Treasury Department's proposal in general terms and the arguments made for the plan. We find the arguments generally persuasive and the approach taken to be a very positive step toward modernizing financial services. The proposal has one glaring weakness--it leaves us out. The Treasury proposal would put banks in a better competitive position with nondepository competitors but would leave savings institutions at a distinct disadvantage. We are prepared to support the approach taken by the Treasury

Department but only if it is expanded to cover savings institutions, of both stock and mutual form.

It would be a relatively simple matter to grant S&L holding companies parity with bank holding companies. But this would still leave the majority of savings institutions out of the new ball game. We are well aware of the fact that the "problem" Treasury has with us is incorporating the mutual institutions into their plan.

We believe that a structure can be developed for mutual institutions that will be consistent with the principal objectives of the holding company subsidiary, i.e. independent capitalization, insulation of risk, and parity of regulation of the subsidiary with independent firms offering the same services. We are prepared to work with the Treasury and this Committee to develop the necessary legislation to accomplish these objectives so that mutual savings institutions will not be placed at a serious competitive disadvantage.

Geographic Limitations

Nowhere is the anomoly between banking law and reality more obvious than the interstate banking restrictions of the McFadden Act and the Douglas Amendment. Institutions such as Sears, Merrill Lynch, and other multi-product financial services firms are free to operate on a nationwide basis; banks and thrifts are not. While a handful of depository institutions have been permitted to cross state lines in emergency cases, this remains generally prohibited.

Prohibitions against interstate banking have been defended as a means to prevent unhealthy concentrations of financial power. The best argument for changing these laws is that they will no longer achieve that objective. They do nothing more than give one set of competitors a huge head-start over the others. The McFadden and other related Acts are, in this regard, counterproductive.

"Nonbank Banks"

One of the more recent and controversial innovations in the financial marketplace has been the acquisition of limited-purpose banks by business firms which would be legally prohibited from acquiring a full-service bank. The Comptroller of the Currency has announced a moratorium on new applications involving limited-purpose banks. In earlier hearings the Chairman of the Federal Reserve Board recommended a legislative moratorium on the acquisition of "nonbanks," including thrift institutions. The purpose of such a moratorium, as we understand the argument, would be to hold the line on these marketplace developments until Congress can decide on a new set of rules or a reinforcement of old rules.

Ideally, the issues of Glass-Steagall, McFadden and the "Maginot line" between banking and commerce should all be considered in concert. We doubt that this can be accomplished. We also doubt that a statutory moratorium will dampen entrepreneurial spirits, which drive the marketplace; it would only channel them to other innovations to accomplish the same objectives.

We strongly support the position taken on this issue by Chairman Pratt in his testimony last week. To impose such a moratorium on savings and loans at this time would be very damaging to our industry. Like Chairman Pratt, we know of no record or incident of abuse resulting from the ownership of S&Ls by nondepository firms. Furthermore, one of the savings and loan industry's most immediate needs is to rebuild the capital eroded by the past two years of operating losses resulting from high interest rates. The moratorium suggested by Chairman Volcker would deny to our industry one very important source of new, private capital.

We also want to point out that the Garn-St Germain Act dealt with this issue with respect to savings and loans. Sec. 335 of the Act says, in effect, that if an S&L which is owned by a nondepository firm uses its new asset powers to such an extent that it no longer meets the tax code definition of an S&L, then it can no longer be owned by the commercial firm. In other words, if an S&L becomes a "bank," it plays by the same holding company rules as banks. This same test is applied to the issue of interstate branching, incidentally, by Sec. 334 of the Garn-St Germain Act. With this law in place, Mr. Chairman, we see no real justification for including thrifts in the "nonbank" bank consideration.

Risk-Based Insurance Premiums

The studies which were recently submitted to Congress by the FSLIC, FDIC, and NCUA, as required by Sec. 712 of the Garn-St Germain Act, will be a valuable source of analysis and data on the workings of the current deposit insurance programs, on the various proposals for change of premium assessments, and on the organizational structure of the insurance funds.

Since the creation of the insurance programs in the 1930s, there have been continuing discussions on the subject of flat-rate versus risk-based premiums, but there has been no analysis of which we are aware, prior to the Sec. 712 studies, which attempts to identify elements of the operation and management of financial institutions which pose risks to their respective insurance funds and to place an actuarial value on these risks.

Last November the National League formed a special Task Force to study the specific questions raised by Sec. 712 and to provide our comments to the FSLIC as it prepared its study for submission to Congress. The Task Force also addressed the Bank Board's advance notice of proposed rulemaking of November 4, 1983, requesting comments on a variable-rate insurance premium based on the interest rate risk of associations' portfolios.

The principal conclusions reached by our Task Force (which, of course, preceded the opportunity to review the agencies' Sec. 712 studies) were as follows:

1. Interest rate risk alone should not be a basis for setting insurance premiums. Such a policy would prove to be a disincentive for mortgage lending. Or it would require associations to be so heavily hedged that profit making would be minimized.
2. There are other kinds of risk to which the insurance fund is exposed, i.e., default risk, and management risk, but the methodology does not yet exist to adequately and objectively measure these risks.
3. The biggest danger in the risk-based premium proposals advanced so far is that of reregulation. Instead of supervisory actions to enforce these new "regulations," the "penalty" would be a higher cost of operation.
4. The FSLIC should not be combined with the FDIC. The present organization of the Bank Board and FSLIC has demonstrated in the recent economic crisis that it can work efficiently and quickly without the problems which have been experienced by the banking agencies.

5. There is no discernable role for private insurance as a substitute for federal deposit insurance, since private insurance would result in reregulation and private insurers would tend to cut off protection when it was most needed, i.e., as a financial institution begins to experience difficulties.

We will, of course, review the Sec. 712 studies with great interest and look forward to providing comments to this Committee at the appropriate time.

Regulatory Reorganization

The last general issue we wish to address here today is the Agency reorganization study being conducted by the regulators and administration officials. Under the chairmanship of Vice President Bush, the group is reviewing the existing financial regulatory structure with the objective of making recommendations to Congress for changes in that structure. Since the report and recommendations are not expected until later in the year, we will only make a few general observations at this time. While the subject of regulatory agency restructuring has been studied several times over the past three decades, it is understandable that it is being looked at again. The dramatic innovations in the financial markets and the recent experience with problem banks and thrifts raise the obvious question--is the present regulatory structure able to assure a stable and reliable financial system and preserve public confidence in the system? The question may be obvious, but the answer is not.

We would ask the members of this Committee and the Bush task force not to let the question dictate a single answer. The consolidation of agencies such as some have proposed will not be the best solution.

Proponents of drastic reorganization or consolidation of the regulatory agencies often point to the changes brought about by legislation and marketplace forces which have "eroded" market boundaries and reduced specialization as justification for their cause. That these changes are occurring and are themselves dramatic is undeniable. We question, however, that this trend has or inevitably will lead to a complete homogenization of the financial services industry. The trend to date, we submit, has not come close to justifying a single federal financial "Super Agency" or anything close to it.

While it is true that the enactment last year of the Garn-St Germain Act makes it legally possible for savings and loan associations to diversify their investment and lending activity, the extent to which this will happen remains to be seen. One thing is certain--it hasn't happened yet nor will it happen overnight. The asset portfolio of savings and loans is still today what it has been for decades--a portfolio of long-term mortgages on American families' homes. How many of these institutions will choose to radically transform themselves is anyone's guess, but even for the most aggressive in this regard the change will be gradual. The pace of their transformation will depend on a multitude of factors not the least of which is their local market opportunities and relative marketplace incentives for different types of investments. It is fallacious to assume that the passage of legislation in and of itself has transformed an industry. It is equally fallacious to argue that there is no longer a need for a specialized regulatory agency.

The Federal Home Loan Bank System and Board were created by Congress some fifty years ago for the purpose of chartering and regulating savings and loan associations and supporting their special role of providing mortgage credit. In the course of these fifty years, through several economic cycles, the system has worked exceedingly well in terms of regulation for safety and soundness as well as enhancing homeownership opportunities. It is a system of which we can all be justly proud. We take issue with those who argue that this system has outlived its usefulness. The demographic demand for housing will remain very strong in the foreseeable future. The desirability of homeownership as a social policy is just as great today as it has ever been.

The Federal Home Loan Bank system has been tested these past 18 to 24 months due to the financial strain put on savings institutions by prevailing high interest rates. The present structure made it possible to handle problems in an efficient, timely, and cost-effective manner while preserving public confidence in the institutions. Had we not had a specialized regulator such as the FHLBB and had it not had within its jurisdiction the chartering, examination, insurance, and "central bank" functions, the problems we experienced would have been far greater and much more costly.

The recent performance of the FHLBB system not only argues strongly for preserving the system but suggests that it should perhaps be looked at as a model for commercial bank regulation. Experience suggests that separating the examination and deposit insurance function is less efficient and more costly than the integrated system. For this reason we would oppose the consolidation of all deposit insurance into a single agency for that purpose alone.

A very recent and important example of the value of the FHLBB as a specialized regulatory agency is the monumental task they have undertaken to implement Title III of the Garn-St Germain Act.

It took the Bank Board only fourteen days after the Act was signed to issue interim regulations covering the major new investment powers authorized by Title III of the Act. We strongly applauded this action as enabling S&Ls and savings banks to begin immediately to take advantage of new authority relating to demand deposits, commercial real estate loans, and commercial consumer loans.

Six weeks later the Bank Board issued for public comment a proposal implementing the entire set of new powers provided by Title III as well as recodifying and simplifying the entire set of regulations which govern operations of federal S&Ls. This proposal was adopted in final form last week by the Bank Board at the last Board meeting which Richard Pratt would attend as its Chairman. The adoption of these regulations is a fitting tribute to his efforts to free S&Ls from the regulatory restraints of the 1930s and to this Committee's leadership in bringing this enabling legislation into being. In adopting these regulations the Bank Board, we believe, has fully met the intentions of Congress and has provided federal savings and loan associations and savings banks with the flexibility which Congress intended.

We respectfully suggest that the task of implementing this new law would not have been done in as efficient and timely a manner but for the fact that there was a specialized thrift regulatory agency to shoulder that responsibility.

Conclusion

Mr. Chairman, we look forward to working with this Committee in the weeks and months ahead as these issues develop. Again, I want to express our appreciation for being invited to participate in these hearings. I look forward to your questions.

The **Chairman**. Thank you, Mr. Coffman.
Mr. Gray.

STATEMENT OF HERBERT W. GRAY, CHAIRMAN, MUTUAL BANK FOR SAVINGS, BOSTON, MASS.; CHAIRMAN, NATIONAL ASSOCIATION OF MUTUAL SAVINGS BANKS

[Complete statement follows:]

Statement
of the
National Association of Mutual Savings Banks
on the
Domestic Financial Services Industry
before the
Committee on Banking, Housing and Urban Affairs
United States Senate
May 4, 1983

Mr. Chairman and members of the Committee, my name is Herbert W. Gray, Chairman of the Mutual Bank for Savings in Boston, Massachusetts, and Chairman of the National Association of Mutual Savings Banks (NAMSB). I appreciate the opportunity to present the views of the savings bank industry before this distinguished Committee on the subjects of structure and competition within the financial service industry.

The National Association represents the more than 400 savings banks in the nation. In New England and New York where they are most heavily concentrated, savings banks are the largest holders of consumer savings as well as the dominant mortgage lenders among the various types of depository institutions. Savings banks are basically community-oriented financial institutions with total industry assets of approximately $176 billion.

As you may know, Mr. Chairman, NAMSB is in the process of effecting a historic merger with the National Savings and Loan League to form a new association representing savings institutions which seek to capitalize on the new financial service opportunities created by the passage of the Garn-St Germain Depository Institutions Act of 1982. That legislation marked the end of mandated specialization and clearly established the framework for savings banks and savings and loan associations to combine into one industry.

State of the Savings Bank Industry

In response to your specific request, I will comment at the outset on the state of our industry. In brief, the current condition and future prospects of savings banking have strengthened dramatically, after two years of devastating pressures in 1981-82. The chief reasons for the turnaround are: (1) the sharp reduction in interest rates late last year; and (2) the enactment of the Garn-St Germain Act. We remain indebted to you, Mr. Chairman, to Senators Riegle and Heinz, as well as to all the Committee members who played key roles in forging the consensus that resulted in Senate passage of that landmark legislation.

The stunning improvement in deposit trends is primarily due to the introduction of money market deposit accounts (MMDAs). Following 27 consecutive months of net deposit losses, the savings bank industry began to attract new funds in December when these accounts were first authorized, and this improvement continued into early 1983. In the first quarter, the industry attracted net deposit inflows totaling $2.8 billion, excluding interest, more than in any comparable period in history. Even after deducting internal transfers from consumer repurchase agreements to MMDAs, the net inflow of deposit and nondeposit funds combined was a healthy $1.8 billion.

Indeed, funds have poured into money market deposit accounts at an unprecedented pace. As of March 31, MMDA balances amounted to $29 billion, or 18 per cent of total savings bank deposits. This surpassed by far the gains recorded in similar periods by other new types of accounts introduced in recent years. Most of the funds flowing into MMDAs resulted from internal transfers from other accounts, but about 20 per cent represented new money from outside the industry. As expected, MMDA gains have slackened on a month-to-month basis since December, as the high introductory interest rates offered on these accounts were brought down closer to market yields. Even so, MMDAs remain popular with savers and continue to attract funds into savings banks. At the end of March, the average rate offered by savings banks on money market deposit accounts was 8.56 per cent.

By contrast, Super NOW accounts have so far proved to be less popular, primarily because of the lower rates offered on these accounts, as well as monthly and per-check fees. Such pricing policies are necessitated by reserve requirements and the costs of heavy transactions activity. Nevertheless, Super NOWs provide an attractive transaction account alternative for some depositors. Balances in these accounts totaled about $1 billion at savings banks at the end of March.

It must be noted, however, that the success of the new accounts has been achieved at considerable cost. In many areas, rates offered on MMDAs were far above market yields during the period immediately following their introduction. Transfers from passbook savings and other lower-rate accounts have exerted upward pressures on overall deposit costs. Furthermore, since funds from maturing time deposits are also being transferred to the new accounts, a major portion of the deposit structure is being shifted into a shorter-term and potentially more volatile form.

The recent shift in the deposit structure has major implications for savings bank investment policy. While mortgage lending has picked up, savings banks understandably are maintaining a cautious investment posture until the stability or instability of the new accounts becomes clearer with experience. Strong emphasis on maintaining adequate liquidity is likely to be a top priority for management. In this regard, the new short-term investment powers authorized by the Garn-St Germain Act are vitally important in enabling savings institutions to restructure their assets in the coming years.

While deposit trends have strengthened, there has also been a major improvement on the critically important earnings front. The late 1982 reduction in market interest rates has been translated into lower deposit interest expenses and a significant improvement in bottom-line income. The beneficial effect of reduced market rates has more than offset the cost-raising impact of money market deposit accounts.

According to preliminary indications, the savings bank industry came close to breaking even on the bottom line for the first quarter of 1983. The recent experience contrasts dramatically with staggering losses amounting to $2.7 billion in 1981-82. Wide variations are evident among different geographic areas, however, and some individual institutions will continue to show losses long after the industry as a whole has returned to profitability.

Together with net worth assistance, the earnings improvement has bolstered the capital position of savings banks. As of March 31, 1983, 21 savings banks had received $195.5 million in net worth assistance authorized by the Garn-St Germain Act. I should state at this point that the implementation of the Net Worth Assistance Act by the FDIC has been expeditious, efficient and very effective. This program has clearly met the congressional objective of providing crucial turnaround time for many weakened thrift institutions to take advantage of declining interest rates and work their way back toward competitive status. All in all, the industry's aggregate capital-asset ratio at year-end 1982 was 5.3 per cent, although net worth remains very thin at some individual institutions.

While the condition of savings banks has improved greatly, it must be recognized that the industry has a long way to go before it is restored to full health. The process will take time because of the need to restructure existing assets and to absorb the effect of deposit deregulation. Further improvement is contingent, moreover, on the continuation of a relatively favorable financial climate. Interest rates must stay down for a protracted period of time, or the recovery will be aborted and the industry's problems will return in full force.

Savings banks remain highly vulnerable to potential increases in deposit interest costs. This is partly due to the fact that a major, though declining, portion of their deposit structure remains in lower-rate accounts. Passbook savings deposits, for example, still represent 26 per cent of total savings bank deposits even after the large-scale shifts to higher-rate accounts.

Furthermore, low-yield portfolios will continue to exert a depressing effect on earnings. The savings bank asset structure remains heavily concentrated in long-term, fixed-rate mortgage loans acquired in earlier years. Three-fourths of total savings bank residential mortgage holdings have rates below 10 per cent, and more than one-half of their holdings have rates below 9 per cent. Savings banks need a lengthy period of relatively low and stable interest rates to work off low-yielding mortgages, as well as bonds, and thereby generate the earnings needed to compete in deregulated deposit markets.

The Depository Institutions Deregulation Committee (DIDC) will meet again at the end of next month, and according to Treasury Secretary Regan's comments during his earlier appearance at these hearings, the DIDC will give serious consideration to accelerating the scheduled phaseout of deposit interest rate ceilings. We will be using this interim period to further analyze deposit trends before commenting to the DIDC as to what additional steps may be feasible. However, we certainly hope the DIDC will not take any overly hasty action that could have the effect of setting back the recovery that is underway in the thrift industry.

One modest but nonetheless important deregulatory step which should be taken at the next DIDC meeting is the removal of the current limitation on the ability of a corporation or other business entity to earn interest on its transaction balances. Much to the detriment of the small business community, the DIDC deferred action on this proposal when it met in March. As we commented to the Committee in our letter endorsing the pending usury preemption legislation (S. 730), the continuation of these limits on business accounts is illogical when restrictions on the interest rates which may be charged business entities are being removed.

Assuming restrained and responsible DIDC action in the months ahead, the chief threat to the thrift industry in the near term is the prospect that massive federal budget deficits will lead to another interest rate upsurge. Unless projected deficits are reduced, interest rates will likely remain at levels that will prevent full recovery of the thrift industry — and indeed, full recovery of housing and the entire American economy. While we realize that fiscal issues are outside the scope of these hearings, we take this opportunity to urge the Congress in the strongest possible terms that action be taken to bring the budget under control.

Asset Deregulation for Depository Institutions

The savings bank industry strongly supports additional financial service deregulation for depository institutions, and we are greatly encouraged by your initiative in calling these hearings to reexamine the Glass-Steagall, McFadden, and Bank Holding Company Acts. The appropriate public policy direction, as clearly mandated by market developments, is to assure maximum flexibility for banking and thrift institutions through progressively broadened powers and services. We cannot continue to perpetuate the current system in which banks and thrifts are limited in their activities while our new competitors are unrestrained. In this context it may be instructive to note that the average savings bank has a branch network of only 10 offices, while Sears Roebuck has just announced that it will open financial centers at another 100 of its retail outlets.

The objective, indeed, the competitive necessity, is to provide each institution with the full opportunity to choose its own structure and its path to long-term strength and prosperity. Testifying before this Committee on April 6, Treasury Secretary Regan outlined a similar position on behalf of the Administration in stating that "all depository institutions should have equal powers and should be free to choose whatever specialization they wish, based on their individual competitive skills and goals." The Secretary went on to say, however, that while this remains the Administration's ultimate goal, only commercial banks should be the participants in the next phase of financial deregulation through a liberalization of the Bank Holding Company Act (BHCA). Mr. Chairman and members of the Committee, if there is a single thought that I would like to leave with you today, it is our adamant conviction that further deregulation must proceed equally and concomitantly for all types of depository institutions - mutual as well as stock.

While we stand ready to work with this Committee and the Administration in developing the appropriate next step in financial deregulation, NAMSB would have to oppose any legislation granting new operating powers to commercial banks to the exclusion of thrift institutions. This would most certainly include the Bank Holding Compaany Deregulation Act as introduced at the request of the Administration in the last Congress (S.~~2591~~ 2490). Bank and thrifts are by now almost fully deregulated in terms of deposit competition, and thus there remains no logical or other justifiable reason for continuing to treat depository institutions differently when it comes to asset powers. Such thinking is anachronistic and reflects, in our view, the unstated assumption that thrift management would somehow be less able than commercial bank management in implementing new powers — an assumption which can hardly stand up in light of current international lending problems, not to mention the mismanagement and abuse of trust which has characterized some recent well-publicized commercial bank failures.

We are familiar, of course, with the Administration's proposal to utilize the holding company device as the vehicle for permitting banks to offer a broader range of financial services to the public. Legitimate arguments have been advanced in favor of the separate subsidiary concept, particularly from the standpoint of regulatory and operational supervision. However, a means can and must be found to permit thrift institutions, including those doing business in mutual form, to take advantage of any new financial service powers. Towards this end, NAMSB acted last December to establish a special task force of bankers and bank attorneys to study this issue, and based on the progress made to date, we believe that a workable means can be found to permit all depository institutions to operate holding company subsidiaries.

Consumers in the marketplace do not distinguish between mutual and stock depository institutions, and the history of the insurance industry amply demonstrates that stockholder-owned and nonstock corporations can operate successfully alongside one another. Indeed, two of the top twenty financial service firms in the country are mutual institutions. Thus we see no reason for the Administration to propose, or for the Congress to accept, any legislative proposal that would discriminate against institutions on the basis of their corporate structure.

It is likewise inadequate to suggest that this problem can be overcome by simply facilitating the conversion of mutual thrifts to stock form. We certainly encourage those steps which the Federal Home Loan Bank Board has taken in this direction, but there are many institutions which, by virtue of tradition, management preference or market conditions, will want to continue to do business as mutuals. The fact of the matter is that a number of institutions believe that they will be better situated to serve their local communities by remaining mutual in form. We look forward to furnishing this Committee with the results of our industry's efforts in developing a holding company structure for institutions which do not elect to undertake a public stock offering.

In the context of discussing holding companies, another important issue is the current "nonbank bank" controversy. Mutual savings banks have a particular interest in this subject since the Federal Reserve's administrative rulings, as typified by the Wilshire Oil proceedings, raise the specific question of whether a savings bank is a "bank" for BHCA purposes. Section 333 of the Garn-St Germain Act settled this question in the negative insofar as savings and loan associations and federal savings banks are concerned, but the status of state-chartered savings banks remains a matter of Federal Reserve interpretation under the BHCA. The statutory test turns on demand deposit activity and degree of commercial lending and, in our view, permitting the Fed to handle the matter on a case-by-case basis within these guidelines is the preferable approach during this particularly fluid phase of financial institution evolution.

While this committee and the Congress is considering the recommendation put forward by Chairman Volcker regarding a possible legislative moratorium on nondepository companies acquiring depository institutions, we would suggest that the more pressing question involves intra-depository acquisitions. At the present time, savings banks are effectively precluded from acquiring commercial banks as separate subsidiaries by virtue of federal regulatory policy. We believe that this policy retards full implementation of the broader asset powers granted thrifts by Garn-St Germain by preventing savings banks from expanding into commercial lending through acquisition of small commercial banks. On the question of the moratorium itself, we cannot comment fully until we have seen an actual proposal, but we would have major reservations about any legislation that could cut off potential sources of investment capital for the thrift industry.

With the enactment of last year's legislation of putting an end, hopefully once and for all, to the concept of mandated specialization, it would appear no longer necessary to maintain these artificial barriers between the various types of financial institutions. Savings bank mergers with savings and loan associations are proceeding in an orderly manner, and we see no reason why savings banks should not be allowed to acquire commercial banks and vice versa.

Geographic Restrictions on Depository Institutions

The continuing trend among the states to liberalize their branching statutes to include interstate activities on a reciprocal and/or regional basis is one of the most significant deregulation steps now underway. We applaud your earlier comments, Mr. Chairman, endorsing these state initiatives, the most notable of which is the so-called "New England experiment." NAMSB policy in this area is that interstate banking developments should be allowed to proceed at the state level.

Savings banks launched the NOW account experiment in New England in the early 1970's, and successfully defended this consumer service over the opposition of other depository groups and certain regulatory authorities. Insofar as branching is concerned, federal thrift institutions, unlike commercial banks, do not presently operate under any statutory prohibitions, but appropriate clarifying legislation might very well be helpful in ensuring equal treatment for all affected institutions. Legislation has recently been introduced (S. 1002 and H.R. 2431), to provide a federal imprimatur to the joint initiative of the New England states. We believe Congress and the federal regulators should encourage the efforts of all the individual states to act in this area while deciding how the subject should be later addressed on a nationwide basis.

Regulatory Reform

The Vice President's Task Group on Regulation of Financial Services is expected to make its recommendations later this year on the subject of financial agency restructuring. The savings bank industry also has a committee examining this subject with a view toward providing additional recommendations to the Vice President's Task Group and the Congress. That committee is headed by Frank Wille, the Chairman and CEO of the Greater New York Savings Bank and former Chairman of the FDIC. In the meantime, we have already had the opportunity to survey our industry's leadership on this subject, and the view was nearly unanimous that no basic change is necessary at this time. The possible creation of one super regulatory agency was deemed to be fraught with problems, both in terms of federal/state relations and loss of flexibility at the federal level.

The present system appears to be working notwithstanding the major financial strains caused by the earnings problems of thrifts in recent years and the continuing loan problems at major commercial banks. The regulators are generally doing an effective job in the area of protecting the public and preventing dishonest and fraudulent activities on the part of financial market participants.

It is true that there are instances of competitive advantage under the current regulatory structure (e.g. FHLBB allows deferred loss accounting while the FDIC does not), but savings bankers do not favor radical restructuring just to eliminate these particular advantages. Rivalry among the supervisory agencies to enhance the competitive status of the institutions under their particular jurisdictions can be just as pro-consumer as competition among the institutions themselves.

With respect to the prospect of merging the federal deposit insurance funds, there is a clear consensus among savings bankers that such a step would produce little by way of real cost savings and could, in fact, be counterproductive by discouraging innovations in banking. Federal savings banks now enjoy the option of choosing their federal insuring agencies, and many state-chartered are covered by state sponsored insurance funds. We believe that the freedom to choose among these agencies is an important opportunity to preserve, and that the insurance agencies would be better served by concentrating their efforts on creating consistencies in regulatory policies and removing obstacles to intra-depository mergers where the merger partners are insured by different public agencies.

Despite the largely negative reaction of our membership to some of the threshold questions posed by the Bush Task Group, we do not reject altogether the notion of change. We recognize that deregulation poses a number of regulatory questions and that some changes, perhaps along the lines of the recommendations recently made by the federal deposit insuring agencies, may be necessary to build greater market discipline into the present system. However, the savings bank industry feels that it might be wise to allow the current deregulatory changes to settle in before making any major modifications to supervisory structure and practices.

Conclusion

I hope these comments have been useful to the Committee, and once again we want to express our appreciation for the major effort that went into last year's comprehensive banking legislation. That bill has been remarkably successful, but much more needs to be done. These hearings have already made a material contribution to this process, and we look forward to working with the Committee in the months ahead.

The CHAIRMAN. Thank you very much, Mr. Gray.

Mr. Muse.

STATEMENT OF WILLIAM B. MUSE, JR., PRESIDENT, IMPERIAL SAVINGS & LOAN ASSOCIATION, MARTINSVILLE, VA.; MEMBER, BOARD OF DIRECTORS, AMERICAN SAVINGS & LOAN LEAGUE

[Complete statement follows:]

STATEMENT OF WILLIAM B. MUSE, JR.
PRESIDENT
IMPERIAL SAVINGS AND LOAN ASSOCIATION
MARTINSVILLE, VIRGINIA

ON BEHALF OF

THE AMERICAN SAVINGS AND LOAN LEAGUE
May 4, 1983

Mr. Chairman and members of the Committee, I am William B. Muse, President of Imperial Savings and Loan Association of Martinsville, Virginia. I am pleased to have the opportunity to present to you the views of the American Savings and Loan League at these oversight hearings on the condition, structure and competition within the financial services industry.

The members of the American Savings and Loan League are those associations owned or controlled by Blacks, Hispanics, Asian-Americans and women groups. Our associations are small and relatively young. Most of them have assets of less than $100 million, and only one half of our membership have been in existence for more than 10 years. In spite of their small size, our member institutions have become an integral part of minority neighborhoods throughout the country. Collectively, minority savings and loans represent over $2.6 billion dollars in assets. They are located in 25 states and the District of Columbia.

Last year when the American League testified on what was to become the Garn-St Germain Act, there were 85 minority savings and loans in the United States. As a result of the severe conditions facing the American economy and the entire thrift industry, our numbers have shrunk to 74. We are encouraged, however, that new associations are being organized and chartered each year. Nevertheless there is great concern on our part for those institutions which have had to be merged or have gone out of business, thereby leaving in their communities a void which may not be replaced in the future.

At the time of my testimony before the House Banking Committee last year, I reported that 7 minority S&Ls had been merged out of existence because of inadequate net worth. I also stated that unless some form of assistance was provided to shore up the net worth of the remaining institutions, more minority institutions and their communities they were chartered to serve would be severely impacted.

Fortunately, the Garn-St Germain bill took into account the fact that minority savings and loan associations should be preserved. Subsection 123 (C) of the Garn-St Germain Act provided as follows:

> "In the case of minority controlled institutions, the corporation (FSLIC) shall seek an offer from other minority controlled institutions before proceeding with the sequence set forth in the preceding paragraph."

The preceding paragraph had to do with emergency thrift acquisitions. We owe a deep debt of gratitude to Senator Alan Cranston who introduced subsection 123 (C) as well as a provision making it easier for institutions to be eligible for capital assistance.

Fortunately, at the same time the Garn-St Germain bill was enacted, interest rates began to fall, thereby improving the national economic situation and easing the earnings squeeze facing savings and loan associations. Thus, not only are we now able to experience a positive spread, but we also now have the new powers enacted under the Garn-St Germain Act that allow minority and other thrift institutions to restructure their portfolios, engage in new lending activities and investments, and plan for becoming competitive within their communities. To be sure, if interest rates were to rise drastically within the next few months, the whole scenario would be different. We are hopeful, therefore, that the Federal Reserve and the Administration will do their utmost in their wisdom to maintain stable interest rates and low rates of inflation.

With respect to the American League's legislative recommendations for this year, I would like to include in the record the legislative program adopted by the board of directors of the American League at its 4th annual legislative Conference held March 22, 1983. Briefly, these proposals dealt with the interest withholding provision of the Tax Equity and Fiscal Responsibility Act of 1983, wherein we urged Congress to repeal the provision requiring institutions to withhold 10% of interest on their savings accounts because of the unnecessary financial burden and the fact that withholding cannot be justified in terms of increased tax revenues. We also support removal of the FHLMC/FNMA dollar limits on mortgages that they may purchase. We believe that now that savings and loans can originate residential mortgages without regard to dollar ceilings, the Federally chartered secondary market agencies should also be able to purchase mortgages originated by these lenders.

The American Savings and Loan League is also opposed to any effort to eliminate or restrict the deduction for interest paid on home mortgages. We also support continued tax incentives for savings as well as 100 percent Federal deposit insurance for IRA and Keogh Accounts. With respect to consolidation of the regulatory agencies, the American League opposes any legislation to consolidate FSLIC, FDIC and the credit union insurance funds and activities.

We support a continued independent Federal Home Loan Bank Board as a regulatory agency for the savings and industry. We also oppose access by commercial banks to the Federal Home Loan Bank System.

Mr. Chairman and members of the Committee, this is an appropriate time I believe for the American League to go on record to congratulate the Federal Home Loan Bank Board under the leadership of former Chairman, Richard T. Pratt, for its concern and sensitivity for the welfare of the thrift industry and minority S&Ls. Without their efforts in support of deregulation and new powers for the industry, as well as their changes in regulations to make life a little bit easier within the regulatory agency's ability, we could not have gotten as far as we have. We extend to Chairman Pratt and his capable staff our deepest gratitude for their interest and concern.

We have recently met with Edwin Gray, the new Chairman of the Federal Home Loan Bank Board, and he has assured the American League that he will continue to be sensitive to the concerns of the minorty institution. We are looking forward to a long and continuous working relationship with Mr. Gray and his new staff.

As I mentioned earlier, it is taking quite some time for American League members as well as the rest of the thrift industry to digest all of the new powers granted to thrifts under the Garn St. Germain Act. Our members are busily reviewing the new powers, adopting plans for the this year and the next five years. Some are converting from mutual to stock form and others are considering combinations with one another. Given this high degree of activity, we are not in the position at this time to propose additional legislation since we feel that we have got enough to chew on and to digest for the time being. We are using our new breathing room to find self help measures for returning to profitability. As you know, the members of the American Savings and Loan League are also members of the U.S. League of Savings Associations. Therefore, we will not go into any further comment on legislative issues.

I would like to bring to your attention one matter with respect to changes in FSLIC premiums--a perspective that might not have been taken into account, but one which we would like to see reflected in whatever premium structure is arrived at.

Recent regulations proposed by the Federal Home Loan Bank Board that would provide premiums based upon the degree of interest rate risk, default risk and real net worth, give us some concern for the following reasons: A risk based premium imposed without statistical guidelines or consideration of special circumstances could lead to discriminatory enforcement and penalty for those associations who do not do business in the "accepted" manner. For example, the Chinese and Asian communities have a much lower default experience. Borrowers don't always appear to possess the financial resources necessary to afford a home, as monies from oversees and from family members do not count under normal underwriting standards. These families also have a very strong moral obligation to pay their debts. Because of the difference in underwriting loans made the "Chinese way" it could be determined that there was a higher risk involved. I should also point out that these same Chinese S&Ls lend the conventional way, using the FHLMC/FNMA underwriting standards, and that they are active participants in the secondary market.

In another instance, lenders serving minority neighborhoods and businesses in inner city areas such as the Watts area of Los Angeles might be penalized. These S&Ls are doing what they were chartered to do, and that is meeting the credit need of their communities. Granted, those living in certain inner city neighborhoods often do not have the economic wherewithal and do not appear to be the best lending risks. For instance, being the last hired, minority individuals are often the first to be laid off. Without considering the great importance of maintaining homeownership to these persons, and looking merely at what appears to be a higher risk of default, not only are the borrowers going to suffer from the unavailability of credit, but the institution will be forced to pay a higher insurance premium.

With deregulation and the ability of thrifts to enter into commercial lending and the desire of the banks to compete for the deposits of more substantial persons and businesses, we are potentially facing a return to the dreaded "redlining" of certain communities and groups. One of our Hispanic members reports that they have begun to do quite a bit of lending to small businesses, mom and pop businesses, because local commercial bankers have abandoned their activities in these areas. To be the sole source of financing for viable businesses and to also have to pay a higher insurance premium for doing so appears to be a high price to pay. Thus, the particular circumstances ought to be taken into consideration before a determination of higher risk is made.

Finally, with respect to adequate net worth, we must point out that half of the minority S&Ls in the U.S. are less than 10 years old and therefore have not had the 20 to 25 years allowed for them to meet the 3 percent requirement. This fact certainly must be taken into consideration when assessing risk in the net worth area.

With deregulation and competition from new entrants into the financial services industry, one might wonder if there is still a place in the market for the minority thrift institution. Mr. Chairman an members of the Committee, I appear before you today to say that yes, there is. What we must now do is to look into our markets and carve out our own niche by looking to see what services our customers need, pricing them appropriately and providing them better than someone else can. It's going to require a lot of work, but we have got the framework in place with the new Garn St. Germain legislation, we have a cooperative and sensitive Federal Home Loan Bank Board under the leadership of Edwin Gray with Board Member Jamie Jackson, and we are encouraged that with a proper interest rate environment the future appears to be bright. We would not at this time propose any further regulation of non-depository institutions, since we believe that we have the tools right now that should allow us to compete and to continue to meet the credit needs of the communities that minority and women's S&Ls serve.

Again, I appreciate the opportunity to present the views of the American Savings and Loan League, and I will be pleased to respond to any specific questions that the committee may have. Thank you very much.

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AMERICAN SAVINGS AND LOAN LEAGUE, INC.

LEGISLATIVE PROGRAM

March, 1983

Interest Withholding Provision of the Tax Equity and Fiscal Responsibility Act of 1982

We strongly urge Congress to repeal the law that will require associations to withhold 10% of the interest earned by individuals, effective July 1, 1983. The unnecessary financial burden imposed on the financial institution cannot be justified in terms of increased tax revenues and will exceed the benefits to the public sector of extra taxes paid.

The 10% withholding of interest also will be a disincentive for savers in minority communities. The minority institution will witness a depletion of savings and will thus have to cut back on many services it provides for the minority residential and business community. Such services include commercial real estate lending, SBA-Guaranteed loans of up to 5% of their assets, Municipal Tri-Party Participations and Rehabilitation Programs just to name a few. This interest withholding provision will only reverse the progress and advancements that minority institutions have achieved. We believe that this provision must be repealed in order for us to continue to perform these such vital functions for our minority communities.

Removal of FHLMC/FNMA Conventional Mortgage Limits

ASLL supports the removal of dollar limits on FHLMC/FNMA mortgage purchases. A viable secondary residential mortgage market is essential to the recovery and continued well-being of the housing and home finance industries. Now that S&Ls can originate residential loans without regard to any dollar ceiling, the Federally-chartered secondary markets should be able to purchase the residential mortgages originated by these lenders. Any conventional mortgage limits inhibit FHLMC and FNMA from purchasing home loans in various parts of the country, such as major urban areas, the West and the Southwest. Parts of the country with a high cost of living should have equal access to the secondary mortgage market. The average conventional mortgage purchased by FHLMC and FNMA has been consistently below the statutory ceiling. Thus, the experience of these two companies demonstrates their strong support of moderate- and middle-income home mortgage financing. The ceilings should be removed because they impede the ability of FHLMC and FNMA to provide liquidity to the mortgage market.

Home Mortgage Interest Deduction

ASLL is opposed to any effort to eliminate or restrict the deduction for interest paid on home mortgages.

Incentives for Savings

ASLL supports continued tax incentives for savings such as (1) a 7% passbook account where the interest is not taxable, (2) an ?Individual Housing Account? to encourage accumulations toward home downpayments' (3) The Education Savings Account. ASLL also supports 100% Federal deposit insurance for IRA and Keogh accounts.

Regulatory Agency Consolidation

ASLL opposes legislation to consolidate FDIC, FSLIC and the Credit Union Insurance Funds and activities. We support a continued independent Federal Home Loan Bank Board as the regulatory agency for the savings and loan industry. We also oppose access by commercial banks to the Federal Home Loan Bank System.

The CHAIRMAN. Thank you very much, gentlemen.

USE CAUTION WITH TREASURY PROPOSAL

Mr. O'Connell, on page 5 of your statement you suggest caution in moving forward with the Treasury proposal which would allow bank holding companies to engage in any activities of a financial nature because it could dilute the effectiveness of the control.

How do you square that position with the existing powers of the S&L service corporations and your request on page 12 that Congress not restrict the flexibility of the Federal Home Loan Bank Board to approve new activities for service corporations?

Mr. O'CONNELL. Well, I think where we come from, Senator, is always that we are different institutions than the commercial banks. Our primary concerns are not the same as those of the commercial banks. We have in the commercial banking business a different type of business, one that is primarily engaged in commercial lending, while the savings and loans continue to be, despite the Garn-St Germain legislation, primarily preoccupied with residential mortgage financing.

We think somewhere along the line, as Mr. Gray suggested earlier, that as we move closer together it's perhaps appropriate we get even closer to the commercial banking business. I would indicate in that connection, however, that we still do not have the fundamental authority that the commercial bank now has and that is the checking account for business firms, which is, as we recommend in the statement, something we hope that this committee will authorize somewhere along the line.

I think I should mention in this connection that we are concerned as to the whole question that has been raised in recent times about the nonbank bank issue. I was interested in reading Mr. Pratt's statement the other day that indicated that the Federal Home Loan Bank Board had no real problem with the commercial business ownership of thrift institutions. To the best of our knowledge, we have about 25 commercial business firms now that own stock savings and loan associations. I would say that based on the Board's testimony the other day there have been no problems connected with that type of ownership. None of those 25, by the way, happens to be a securities firm, to the best of my knowledge.

The CHAIRMAN. The FDIC has recommended for purposes of the Bank Holding Company Act that banks should be defined as any federally insured depository institution.

What are your views on that recommendation?

Mr. O'CONNELL. Again, I think we are substantially different than the commercial banking business. As I indicated in my statement, we have—thanks to you and the other members of the committee and thanks to the House committee—we finally have the Garn-St Germain legislation. But that law went through last October and we've only had in the last week the implementing regulations put out in final form. So we are a substantial distance away from the kind of institution I think Chairman Isaac talked about.

The CHAIRMAN. Mr. Coffman, you don't feel either that all institutions that serve as depositories and have Federal insurance should have the same separation of powers as far as between banking and commerce?

Mr. COFFMAN. Well, let's put it this way. I think that you have given us the authority with your act which has been a great, great help, especially in communities like where I live and different places—small communities—but you haven't turned us loose yet. We can't go to the little merchant and really ask for his commercial account because we really don't have those powers to go in there. Even the "Mom and Pop" stores are incorporated as a matter of tax convenience. So you haven't given the savings and loans the real opportunity to go out and be aggressive as far as competing with our commercial bank who are across the street from us, and until we get those little extra gifts we've got to have commercial checking accounts, free type accounts, that we can go out—and I've always said that we can loan on a pile of walnut hulls then if we want to and then get on down the road like a bank. And until then, we're kind of stopped. And we turned the corner. We're starting to make a profit now and we've done a lot of things and this has been all through your help and we appreciate that, but still we've got to have that one more shove to get us into the commercial lending business so we will be a full service organization which we are not today. We're crippled that way.

EXCLUDING REAL ESTATE FROM TRUTH-IN-LENDING ACT

The CHAIRMAN. Mr. O'Connell, on page 14 you recommend excluding residential real estate loans from the Truth-in-Lending Act. Would you explain to the committee why you make such a recommendation and why you do not think that is appropriate to be included in truth-in-lending?

Mr. O'CONNELL. Again, the Truth-in-Lending Act has been a very complicated sort of requirement. As I recall, there are hundreds of pages involved. We have a person on the U.S. League staff who spends virtually all of his time working on trying to keep our members advised about truth-in-lending requirements. It's one of those things that once sounded very good, and yet as the time has gone on it's become more and more a burden to our institutions in terms of providing information. I'm not sure just how much good it's really done as far as consumers are concerned.

The CHAIRMAN. Mr. Muse, do you agree that residential real estate should be excluded from truth-in-lending?

Mr. O'CONNELL. I would see no harm in that at all. I think the public is adequately prepared and the public is much more sophisticated, frankly, about interest rates than it was some years ago. Again, if I thought there was a real problem—we thought there was a real problem in this area for consumers, I think we would say, obviously there's need for some sort of truth-in-lending statute. But we don't believe there is and we don't find that the consumers coming into our institutions are unfamiliar with the whole question of interest rates, loan fees and the like.

The CHAIRMAN. Mr. Muse?

Mr. MUSE. Mr. Chairman, we do need some modification and some relief in the statute. I'm in the middle of a supervisory examination currently that I hope will end today and I am looking at that issue. As a small institution, the breadth of the truth-in-lending statute and doing the paperwork for it—is much more comprehensive than I thought it would be 5 years ago. A person must have a degree in actuarial science in order to be able to understand it, and even then you may not be able to comply with TILA. But certainly I think that the consumer protection concerns of Congress can be met with considerable modification from what we are required to do now in our industry.

The CHAIRMAN. Well, I think all of you know my position on truth-in-lending. I have to play the devil's advocate occasionally in order to draw out your position. But I have spent a whole career in the Senate trying to simplify truth-in-lending, not because I oppose it and not because I don't think it was a good idea—it was. Borrowers should be entitled to understand what they are borrowing and be able to shop and how the consumer groups continue to defend truth-in-lending as it evolved I am not capable of understanding. It is a regulatory nightmare that does not give needed information.

I remember sitting here 2 years ago with members of the regulatory agencies here, all sorts of witnesses, and virtually a full committee in markup, and trying to add truth-in-lending simplication to the 1980 act, and none of us could agree on what was being disclosed and we had big charts there and over here and I asked the question in that hearing if we who were supposed to be experts in truth-in-lending and the Fed and all of the various regulatory agencies could not agree on the forms and what was being disclosed, then how could we expect some poor unsophisticated borrower coming into the institution to understand it? So it isn't just a matter of removing the regulatory burden on the institutions to simplify, it's a matter in my opinion of getting back to the intent of truth-in-lending, that a borrower coming in understands what is being disclosed to them in the terms of their loan.

Former Senator Bob Morgan and I in the first year in the Senate were patted on the back and given great credit for simplifying RESPA and until about 2 years ago I complimented myself on being part of that effort, being freshmen Senators and he and I got a bill passed in our first year in the Senate and do this great thing on RESPA. Then, I took out a home mortgage 2 years ago and as I sat there with my banker handing me this and that form to read and sign I thought it really must have been bad before we simplified it because the chairman of the Banking Committee did not understand what was being disclosed to me under RESPA. One of these days I'm going to take the time in that file to go home and read what I signed 2 years ago. Somehow I wish we could get the consumer groups to understand that those laws intended to serve the consumer have not done so and have created a great regulatory burden.

So I would go further than just excluding residential real estate. I would like to see a form about this big [indicating] that says you have borrowed "*x*" number of dollars and you will pay back "*x*" number of dollars, and your APR is "*x*" and about five disclosures are all that is necessary. And then they would understand because I even did an informal survey once, not very scientific, but I had the wastebaskets emptied in some of the lobbies of the depository institutions in my home city of Salt Lake City and by actual count more than 70 percent of those disclosure forms were thrown in the wastebasket of the institutions before they even left the institution.

So I was playing the devil's advocate. I'm on your side.

Mr. Coffman. May I add one thing? I think this is ironic and this plays back to what you're saying. Last month our institution was examined and I'm in the Home Loan Bank district of Little Rock. They are so busy down there that they called in the Home Loan Bank examiners from Topeka. These examiners were from Lincoln, Neb., and came into our shop. They had never been to Arkansas, which was nice and they enjoyed the water and all those things, but they examined us and on nine loans out of our portfolio they found us over one-eighth of 1 percent tolerance on the APR. They threw a fit. I said, "Well, this is the way we've been doing it. This is the way the Home Loan Bank in Little Rock told us to do it. We have bought the Packard computer for each loan officer so she or he can program it and put it into the system." They said, "That is not the way it works." I said, "That's what the Home Loan Bank of Little Rock told us." They said, "We're from the Home Loan Bank of Topeka and we're examining you and we want it that way."

Now that's showing you how all this truth-in-lending works. I tell you, it is a whole nightmare. We have nine people we have got to contact, nine couples, bring them back to the organization or go to them and we have to make refunds up to $19 or $20 to each one of them because the tolerance was different. We have to re-sign these people up and in a State like Arkansas where usury has been a big problem all of our lifetime, can you feature the flack we're going to have from those nine couples? There's no telling.

But we're talking about the difference between the way the Home Loan Bank in Little Rock figured it and what their examiners told our people. They went to school and bought the machine and now the Topeka people are telling us that the Little Rock people don't know what they're doing.

So, as I said, I talked to Joe Suttle the other day in Albuquerque and I said, "Joe, the Home Loan Bank in Topeka says"—and he said, "We're having quite a bit of trouble like that and we're going to overlook it." Well, we can't overlook it when they write you up and then you've got to respond to the letter.

I'm with you, Mr. Chairman. I think if they would get truth-in-lending, you've got to remember you come in and ask for a loan in my institution my staff has to spend about 45 minutes filling out this telling you what we're going to do to you before we ever get a chance to do it. [Laughter.]

This regulation has finally gotten to the point, as I said, I'm a country boy from down there and I believe in doing it simple. I was raised up to write a check on a paper sack and take it to the bank and get it cashed. Now unless you've got all those numbers on it they won't even look at you.

The Chairman. You believe in the KISS formula, "Keep It Simple, Stupid?"

Mr. Coffman. I sure do.

The Chairman. Senator Lautenberg.

Senator Lautenberg. So many opportunities for good humor here this morning, I think, Mr. Coffman, life is such that you always telegraph what you're going to do before you do it one way or another. It's been a kind of accepted practice in our society.

That doesn't sound like it's the thing that got you in trouble. The thing that got you in trouble is you've got the wrong computer. [Laughter.]

You'll have to understand my background before you understand that.

But we have serious business at hand and I think that the seriousness of our discussion to me revolved around whether or not you and your industry, the savings banks, the savings and loans, related thrift institutions, have a unique marketplace, unique responsibility, a unique consumer, or are you offering or would you like to offer the same product that any commercial bank offers? I hear some differences. I think they are shades of difference rather than marked dichotomies, but I'm concerned about it. And I wonder if any one of you would like to respond. Was there a unique marketplace that the savings institutions were serving?

Mr. O'CONNELL. I would say that it was clearly designed by the Congress in the 1930's. They decided to split up and divide the responsibilities among financial institutions or financial and service institutions, and they came out with a prescription for the savings and loans and put them virtually entirely in the residential mortgage field. That was where we have been for many years. Frankly, the fixed-rate mortgage got us into a terrible situation a couple years ago, when we had inflation and very high interest rates.

Senator LAUTENBERG. OK. Forgive the redundancy. I did understand the business you're in. I just want it restated for the purpose of our discussion here because the thing that concerns me is how do we continue to serve that marketplace? The homebuilding industry in this country has been a great contributor to our national economic product. The concept, the notion of individual homeownership, has become an ideal for America and for Americans generally. How do we continue to insure that that market, that opportunity, is going to be there when in fact there are so many more attractive opportunities for investment?

HOMEOWNERS UNABLE TO COMPETE FOR CREDIT

Mr. O'CONNELL. Senator, the fact is that the home buyer until 1965 and 1966 was always able to compete for credit in the open market with even the largest corporations in this country. He paid no more than, say, General Motors or anybody else for credit—the home buyer did. As a result of the inflation that grew out of the Vietnam War and developed into the high interest rates and the volatility of interest rates, he no longer was able to compete.

I think frankly—and I'm optimistic—I have to be optimistic in the job I have—but I think I'm optimistic about inflation and I'm optimistic about interest rates and I think you have a chance to move in the direction of where we used to be in this country. It is possible, of course, to do some things that would make it easier for people to own homes and to compete for credit. Probably the most direct device would be some sort of a tax incentive for savings for home downpayments and that sort of thing. But I think that we are moving in the direction of where the home buyer is—and certainly the recent statistics so indicate—he's beginning to compete pretty effectively as he traditionally did in this country.

Senator LAUTENBERG. At substantially different costs, however?

Mr. O'CONNELL. I would say that's true.

Senator LAUTENBERG. The capital cost configuration now means that much more will be going into interest costs because he will be competing in the marketplace.

Mr. O'CONNELL. That is correct.

Mr. GRAY. Unless public policy is willing to revert to the system of several years ago, then it seems to me that the only alternative is to make it possible for all kinds of competing financial services institutions to find the mortgage market attractive rather than try and restrict one type of institution or another to that particular market. Otherwise you have to give that institution all kinds of special consideration and special help to compensate for lack of full competitiveness.

Senator LAUTENBERG. I'm inclined to agree with you, Mr. Gray. The thing that I'm trying to find out is where is the opportunity for the traditional consumer that you serve to find that mortgage money, to make that investment again in an important industry and an important American ideal? And frankly I don't think it's going to be there, despite encouragement by many that we are seeing fixed-rate, long-term mortgages come back. The chairman will get tired of hearing me go through this litany. I listened very candidly to the compliments paid to the Garn-St Germain Act and I see that it has resulted in a more secure financial services complex in our society and I respect and understand that.

If there is any area of concern or perhaps disagreement—we're obviously in different parties but not in different interests in our country—and the chairman left himself terribly open before when he said he couldn't understand the material that was developed—I won't pick up because I'm still a junior on this committee—the fact is that maybe we have to do something different and it's hard to imagine that one segment of this financial complex of ours in this country ought to be restricted in one and has to service the home mortgage market while the other segment goes off and has a good time and offers any kind of profit you want.

There's some difference, Mr. O'Connell, in terms of the product lines that I think you're urging and that which Mr. Coffman is talking about.

Mr. O'CONNELL. I would say that obviously we share the same hopes that the members of the committee do, so far as homeownership in the country is concerned.

I also think that we looked at the Garn-St Germain legislation as an alternative approach so that we would never get caught in the trap of fixed-rate mortgages again, which has been the reason for our desperate situation in recent years.

Senator LAUTENBERG. You're about the most forthright witness in that regard—I'm not talking about character; I'm talking about that statement—"getting caught in that fixed rate, long term mortgage trap again." So few people are willing to admit—I'm talking about professionals in the financial industry—that that's almost a thing of the past. I don't care what happens to the interest rate, that memory is going to last a long time and what happened to the banks when they were caught by the mortgage market when they had extended terms of loans and couldn't afford to meet their obligations.

INSTITUTIONS RETURNING TO FIXED-RATE MORTGAGES

Mr. O'CONNELL. One of the things that troubles us is that many of our institutions are returning indeed to fixed-rate mortgages, primarily because I think consumers are worried about the return of inflation and the return of skyrocketing interest rates. The customer gets a 12-percent loan today and thinks maybe we'll go to 20 percent somewhere along the line. I don't share that view. I'm asked very often, "Do you think the savings and loans are going to become commercial banks?" And I think the answer really is that it depends upon what the public acceptance of the adjustable mortgage loan is. If we continue down the road of taking over the fixed-rate loan market again, in the event we get a return of inflation, in the event we get a return of high interest rates, we're heading for another round of terrible trouble.

On the other hand, we must help the consumer understand that the adjustable mortgage loan program protects financial institutions and indeed protects the buyer of the house. Because if we're not in that mortgage market somewhere along the line, there's no liquidity for that home to be sold, and that diminishes the value of the house that's purchased by the homebuyer.

I would hope somewhere along the line we could get that story across to the American people. And anything that this committee could do would be appreciated. We're going to try really hard in the coming year, frankly, to market the adjustable mortgage loan because I think that's the key to whether or not this business moves into more and more of a commercial banking-type business.

Senator LAUTENBERG. Mr. Coffman?

Mr. COFFMAN. I'll tell you, here's the thing we need to think about, and I realize that you're not here to help change our business and all but you're here to help the American public be a homeowner, and I think that's what you're talking about, and I think the total key to this is to get us—all financial institutions involved in real estate sales, in real estate total development, in real estate financing. Now if you could put the sales profits to us, you take a 7-percent commission on every $100,000 house it's more than a savings and loan ever makes off the interest rate in 30 years. That commission—Century 21 is already in the business of financing for their sales. They are part of a conglomerate. They're already in our business. But if we mention getting into their business, they say, "Oh, no, don't do that. Don't think about it." But the thing is, we need that front money to survive and then we could come in with a GEM mortgage that would pay out in about 15 years that would work. The average home loan is 12 years—a few years ago it was 7 and it went to 12 after the economy slowed down—so if we can get a GEM mortgage that will pay out in 15 years with the 30 year amortization, then we can compete with the front money on the sale of the real estate, evidenced through our service corporation for development of land in the subdivision. A

GEM mortgage with that increase will not affect the normal working man at all. He can handle that.

That's where we stand today. We've got to have help to let us be a total financial institution. I'm not saying be a bank completely. I'm saying let's stay in the home mortgage business. That's what we want.

Senator **Lautenberg**. You may not change the title, but I think you want to change the function.

Mr. **Coffman**. That's right.

Senator **Lautenberg**. I don't necessarily disagree. I don't think one segment ought to be disadvantaged and the other be moving merrily along. Why should you be the only one servicing the consumer who needs the mortgage loan? I'm sorry, I'm out of time. Thank you, Mr. Chairman.

The **Chairman**. Let me just say before I turn to Senator Hecht, that, Senator Lautenberg, that I won't be worried about the compliments about Garn-St Germain and they will continue as long as I'm chairman of the committee. They will undoubtedly diminish if I'm not on the committee.

Senator Hecht.

Senator **Hecht**. Thank you, Mr. Chairman.

This dissertation between you and Mr. Coffman, although we all laughed about it, is really not a joke because the amount of time invoved with the secretary and in not having the right secretary the time the officer has to sit and explain to the person sitting there, it's just about a ½-hour minimum on every transaction, if you're lucky, a half an hour. That's with the customer in front of you. All the preliminary work up until that stage is a tremendous cost of business today to serve no purpose. So we can all laugh about it, but it's very, very important and anything we can do to get rid of this cost of operation that serves no purpose would indeed be worthwhile.

Mr. O'Connell, just at the end there you mentioned get rid of the fixed rate. What type of mortgages are you doing right now? How are you working them out?

Mr. **O'Connell**. I would say that our people are trying to sell customers adjustable mortgage loans and are finding a great deal of consumer resistance to the AML, and so most of the loans being made today are fixed-rate mortgages.

Senator **Hecht**. How many years?

Mr. **O'Connell**. It runs all the way from 20 to 30 years.

Senator **Hecht**. And roughly what is your present rate?

Mr. **O'Connell**. I would say 12 to 13 percent on conventional loans.

Senator **Hecht**. And how many points do you charge?

Mr. **O'Connell**. Usually 2—1.5 to 2, depending on whether it's an existing house or a new house.

Senator **Hecht**. I'll ask you and Mr. Coffman another question. You want to expand, but you want to keep the same regulator FSLIC over the FDIC coming in, but you want to get all the other functions. Can you answer that?

Mr. **Coffman**. Well, yes, I really can. The FSLIC does the same thing as the FDIC. The only thing I'm saying is that we have been regulated by the people for the past 50 years and I think a change right now would be wrong. I believe we have the public confidence, and I'm not saying there's not confidence in the FDIC, but we are used to those people. They've done the whole thing. They've done a good job for us. We do not have to go to different agencies. In other words, you've read about the banks that have failed. It's been one agency that knew about it and the other agency didn't ever function. Our agency is all one agency so that's a stop that would help protect the depositors in the savings and loan business. I'm not against a change in insurance if that came to the fact to maybe get some of these other things. What I'm saying is that we're operating well. The banks have their system and we have our system, but I say still that we're regulated OK because one group does it and there's not someone else having to go to the Comptroller of the Currency and the FDIC or someplace like that. You say I want a change. I want to change to the fact that I can be a total service to our people because we're having to compete in that market with a broker house and everybody else for this money and we've not been able to be aggressive.

I want to say something about Mr. O'Connell in a second. We're charging 11.75 now in Arkansas for a loan, one point on the front, and glad to make the loan. We're advertising for the loan. We're staying open on Saturdays to take applications so the worker won't have to take off work. We're trying to do everything in the world to stimulate the business. We're not making fixed rate mortgages, no. We're making a 5-year AML and we think in 5 years that a person—and we're putting a floater on it at roughly 11.75 on the AML with a ceiling on it of approximately 14 percent, and I think that's aggressive. We're trying to do that and I think people, the American public, can be housed if they're willing now to start out there and find a house that suits them.

Senator HECHT. Let's get back again to that. You're making 11.75?

Mr. COFFMAN. At 11.75, 5-year AML.

Senator HECHT. What's an AML?

Mr. COFFMAN. That means adjustable mortgage.

Senator HECHT. At the end of 5 years it will adjust. What are you basing the longevity of it on?

Mr. COFFMAN. It's amortized on a 30-year payout.

Senator HECHT. Thirty years with a balloon or a renegotiation, right?

Mr. COFFMAN. Renegotiation. That's really true, yes.

Senator HECHT. And you guarantee a renegotiation?

Mr. COFFMAN. Yes, sir.

Senator HECHT. What if the person cannot come up with—let's say we do have what we don't want, a 20 percent prime rate?

Mr. COFFMAN. We have a ceiling on it at 14 percent and we have a floor at 11.75.

Senator HECHT. OK. Mr. O'Connell, would you address that question of one regulator? I don't know if you mentioned it in your remarks.

COMPETITION BETWEEN REGULATORS BENEFITS PUBLIC

Mr. O'CONNELL. I would say that we are satisfied with the regulatory setup for something besides the reason that Mr. Coffman related, which was because we have all these regulators in touch with us under one roof. I would say there's great benefit to the public, frankly, in having diversity among the regulatory agencies. I think it would be a terrible thing, frankly, if we had just one regulator because that would mean that there is no competition between the regulatory authorities, and I think the dangers implicit in that sort of a situation would be very great. If this monolithic, super agency was wrong, then all of sudden you've got tremendous problems running through the economy.

On the other hand, the way the situation works now, there's a fair amount of competition among these regulators. They help watch each other and make sure performance is reasonably good. I think the competition between the agencies is very healthy for the financial community and very healthy for the public.

Mr. GRAY. It seems to me that if you look closely at the performance of the last 2 years you will see that the creative tension between these agencies helped to develop some of the solutions to the problems of the thrift industry. This might very well not have happened had there been a monolithic agency capable of making an absolute decision.

Mr. O'CONNELL. I would agree with Mr. Gray's estimate on that.

Senator HECHT. Mr. Gray, my next question is directed to you. In your testimony you mentioned State regulations. Let me ask you this, practically speaking. Do you think you're better off going the individual State route or the Federal route?

Mr. GRAY. From a personal point of view, I believe the Federal route and, in fact, our institution will be converted to a Federal savings bank in a few weeks.

Senator HECHT. Forget the selfish viewpoint.

Mr. GRAY. There's still no question about it in my view, because of a combination of circumstances which permit an invitation to retain State powers as a result of grandfathering, and still take advantage of Federal powers. Thus, from our position, it makes eminent sense at this point to go the Federal route.

Senator HECHT. Don't you think the individual States achieve this?

Mr. GRAY. They could and I think as a result of some of the conversion activity this will happen more and more. This is something that the dual banking system has brought about, again by way of creative tension between the Federal legislature and the State legislatures. Over time, this brings improvements to our entire financial services industry.

Senator HECHT. No further questions, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Hecht.

Gentlemen, I hate to cut this off, but I've just been told by Senator Lautenberg that we're expecting a vote on the floor in 15 or 20 minutes and we do have two other witnesses to appear before us today and once that bell rings for a vote it will be difficult to get people back. Thank you very much for your testimony.

Our other panel is Joseph N. Cugini, chairman, Credit Union National Association; and John J. Hutchinson, president, National Association of Federal Credit Unions.

Mr. Cugini, would you like to proceed, please?

STATEMENT OF JOSEPH N. CUGINI, CHAIRMAN, CREDIT UNION NATIONAL ASSOCIATION

[Complete statement follows:]

TESTIMONY
OF
JOSEPH N. CUGINI
CHAIRMAN
CREDIT UNION NATIONAL ASSOCIATION
BEFORE
THE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
OF THE
UNITED STATES SENATE
ON FINANCIAL INSTITUTION OVERSIGHT HEARINGS
MAY 4, 1983

The Credit Union National Association, Inc. (CUNA) is an association of credit union leagues, representing each State, the District of Columbia and Puerto Rico. Through the leagues, CUNA represents approximately 20,000 federally and state-chartered credit unions which service more than 48 million members. Credit unions are cooperative, non-profit associations that offer various financial services to their members.

Good morning. My name is Joseph Cugini. I am the Chairman of the Credit Union National Association, Inc. (CUNA) and President and General Manager of the Westerly Community Credit Union, a state-chartered credit union in Westerly, Rhode Island.

CREDIT UNIONS FARE WELL UNDER DEREGULATION

It is almost two years to the day from the time CUNA testified before this Committee in oversight hearings on the condition and structure and competition within the domestic financial services industry. The product of those hearings, Public Law 97-320, addresses the major issues raised by the Credit Union National Association in our 1981 testimony. On behalf of the entire credit union industry I wish to express our sincere gratitude for the vision and leadership of the Chairman and Members of this Committee in securing the passage of the Garn-St Germain legislation.

Credit unions are implementing the new authority and using the greater operational flexibility provided in the Garn-St Germain Act at a measured pace. At the same time, credit unions are also adjusting to the greater responsibility placed on individual managers and boards of directors by deregulation. This

CHANGING ENVIRONMENT HAS PROVIDED CREDIT UNIONS AND THEIR MANAGEMENT WITH SIGNIFICANT OPPORTUNITIES AND CHALLENGES.

TWO YEARS AGO, WE FELT IT IMPORTANT TO STRESS TO THE MEMBERS OF THIS COMMITTEE THAT NEW POWERS, GREATER RESPONSIBILITIES AND BROADER OPPORTUNITIES TO SERVE MEMBERS WOULD NOT CHANGE THE BASIC PURPOSE OF CREDIT UNIONS. CREDIT UNIONS REMAIN MEMBER-OWNED, COOPERATIVE FINANCIAL INSTITUTIONS. THEIR MEMBERSHIP IS STILL LIMITED TO PERSONS WITHIN A FIELD OF MEMBERSHIP, LARGELY THAT OF EMPLOYMENT OR ASSOCIATION. THEY ARE DEMOCRATICALLY CONTROLLED WITH EACH INDIVIDUAL MEMBER OF THE CREDIT UNION HAVING ONE VOTE REGARDLESS OF THE NUMBER OF DOLLARS ON DEPOSIT IN THE CREDIT UNION.

CREDIT UNIONS HAVE CONSISTENTLY AND STEADFASTLY MAINTAINED A COURSE, BOTH LEGISLATIVELY AND OPERATIONALLY, WHICH GUARANTEES A CONTINUED DEDICATION TO SERVICE TO OUR SAVING AND BORROWING MEMBER-OWNERS. THERE IS NO BLURRING OF THE DISTINCTION BETWEEN A CREDIT UNION AND A BANK OR SAVINGS AND LOAN ASSOCIATION. THE VERY STRUCTURE OF CREDIT UNIONS ENSURES THAT EVERY PENNY EARNED IN EXCESS OF OPERATING EXPENSES, REQUIRED RESERVES AND UNDIVIDED EARNINGS IS RETURNED TO OUR MEMBER-OWNERS.

THE NATIONAL CREDIT UNION ADMINISTRATION (NCUA) HAS BEEN A LEADER IN EFFORTS TO DEREGULATE THE FINANCIAL INSTITUTION

INDUSTRY. NCUA CHAIRMAN EDGAR CALLAHAN HAS REPEATEDLY REMINDED CREDIT UNIONS THAT "NCUA DOESN'T RUN CREDIT UNIONS." MAJOR AREAS OF DEREGULATION INCLUDE: STREAMLINING THE LENDING REGULATIONS; ELIMINATING ALL REGULATORY RATE RESTRICTIONS ON SHARES, SHARE DRAFTS, AND SHARE CERTIFICATES; EXPANDING MERGER AND CHARTER POSSIBILITIES FOR FEDERALLY CHARTERED CREDIT UNIONS WITHIN THE LIMITS IMPOSED BY STATUTE; AND EXPLORING THE FULL VARIETY OF SERVICES THAT MAY BE OFFERED MEMBERS UNDER THE FEDERAL CREDIT UNION ACT'S INCIDENTAL POWERS CLAUSE AND SERVICE ORGANIZATION AUTHORITY.

AS NCUA SHIFTED FROM A DETAILED AND OFTEN REPETITIVE SET OF REGULATIONS, IT INCREASINGLY EMPHASIZED SAFETY AND SOUNDNESS THROUGH A BETTER EXAMINATION PROGRAM. AUTHORITY FOR MAJOR DECISIONS WAS DELEGATED FROM WASHINGTON TO THE SIX REGIONAL DIRECTORS WHO, BECAUSE OF THEIR CLOSENESS TO THE ACTUAL OPERATION OF CREDIT UNIONS, ARE IN THE BEST POSITION TO MAKE THE DECISIONS AFFECTING THE DAILY OPERATIONS OF THE CREDIT UNIONS THEY REGULATE.

DEREGULATION HAS OCCURRED NOT ONLY AT THE FEDERAL LEVEL, BUT AT THE STATE LEVEL AS WELL. DURING THE PAST TWO YEARS, A NATIONWIDE PROGRAM BY THE CREDIT UNION NATIONAL ASSOCIATION HAS SEEN LEGISLATION ENACTED IN ALMOST EVERY STATE THAT GUARANTEES

THAT STATE-CHARTERED CREDIT UNIONS WILL CONTINUE TO INNOVATE AND EXPLORE BETTER WAYS TO SERVE THEIR MEMBERSHIP. THE 85 X 85 CAMPAIGN WAS DESIGNED TO MEASURE STATE CREDIT UNION LEGISLATION AND THE FEDERAL ACT AGAINST AN IDEAL, OR MODEL ACT DEEMED BEST SUITED FOR CREDIT UNION OPERATIONS BY CREDIT UNION LEADERSHIP. WE ARE PLEASED TO REPORT THAT 33 STATE ACTS NOW HAVE ACHIEVED 85% OF THAT STANDARD AND MORE ARE EXPECTED TO ACHIEVE THAT RANKING BY 1985.

GENERAL FINANCIAL CONDITION OF CREDIT UNIONS

CREDIT UNIONS HAVE FLOURISHED IN AN ERA OF DEREGULATION AND EXPANDED AUTHORITY. THE 1982 YEAR-END FINANCIAL RESULTS FOR CREDIT UNIONS DEMONSTRATE THIS. TOTAL SAVINGS GREW BY 17.2% TO $41.3 BILLION. LIQUIDITY INCREASED BY $5.1 BILLION, AND OVERALL RESERVES IMPROVED BY $1.8 BILLION.

DURING 1982, THE GROWTH IN TOTAL SHARES HELD BY FEDERAL CREDIT UNIONS WAS 4 TIMES THAT OF 1981 AND WAS FASTER THAN THAT OF ANY OTHER TYPE OF FINANCIAL INSTITUTION. OVERALL, CREDIT UNIONS' SHARE OF THE CONSUMER SAVINGS MARKET INCREASED FROM 4.2% IN 1981 TO 4.5% IN 1982.

THE WEAK ECONOMIC CONDITIONS OF THE PAST TWO YEARS HAVE HAD AN IMPACT ON CREDIT UNIONS. DURING 1982, THE 5-YEAR DECLINE IN

THE TOTAL NUMBER OF ACTIVE CREDIT UNIONS CONTINUED. HOWEVER, NCUA, USING ITS MORE FLEXIBLE MERGER POLICIES, ACCOMPLISHED A SIGNIFICANT CHANGE IN THE WAY CREDIT UNION LIQUIDATIONS WERE ACCOMPLISHED. UNDER THE REVISED NCUA POLICIES, WHEN, FOR INSTANCE, A MANUFACTURER SHIFTED LOCATION OR CLOSED A PLANT, A CREDIT UNION SERVING THOSE EMPLOYEES COULD SEEK A MERGER WITH ANY OTHER OCCUPATIONAL OR ASSOCIATIONAL-BASED COMMON BOND CREDIT UNION. THIS RESULTED IN A REDUCTION IN THE COST OF LIQUIDATIONS TO THE INSURANCE FUND AND PERMITTED CONTINUED CREDIT UNION SERVICE TO MEMBERS WHERE IT WOULD NOT HAVE BEEN POSSIBLE IN THE PAST.

ONE OF THE MOST SIGNIFICANT DEVELOPMENTS IN THE CREDIT UNION COMMUNITY OVER THE PAST SEVERAL YEARS HAS BEEN THE EMERGENCE OF THE CORPORATE CREDIT UNION SYSTEM. ESSENTIALLY, CORPORATE CREDIT UNIONS ARE CORRESPONDENT BANKS FOR CREDIT UNIONS. THE 42 STATE AND REGIONALLY-ORIENTED CORPORATES OPERATE IN CONJUNCTION WITH THE CENTRAL LIQUIDITY FACILITY AND PROVIDE FOR THE INTERLENDING OF LIQUID CREDIT UNION ASSETS. DECREASED LOAN DEMAND DUE TO HIGH INTEREST RATES AND OTHER FACTORS HAVE UNDERSCORED THE NEED FOR SUCH A SYSTEM. U.S. CENTRAL, THE CAPSTONE OF THE CORPORATE SYSTEM, HAS BEEN GIVEN THE HIGHEST POSSIBLE RATINGS BY THE STANDARD BOND RATING COMPANIES. THE GARN-ST GERMAIN ACT NOW

PERMITS NCUA'S REGULATIONS TO REFLECT THE SPECIALIZED NATURE OF THESE CREDIT UNION INTERMEDIARIES. THIS IMPORTANT LEGISLATIVE STEP HELPS ASSURE CONTINUED CORPORATE CREDIT UNION GROWTH AND SERVICE TO MEMBERS.

CREDIT UNIONS AND THE 98TH CONGRESS

THE GOAL OF CREDIT UNIONS IS TO CONTINUE TO MEET OUR MEMBERS' SAVING AND BORROWING NEEDS. CREDIT UNIONS DO NOT WISH TO BECOME RETAILERS, MANUFACTURERS, OR FINANCIAL CONGLOMERATES. CREDIT UNIONS HAVE NOT SOUGHT AND DO NOT PLAN TO SEEK COMMERCIAL LENDING POWERS. BUT THERE ARE A FEW AREAS WHERE WE BELIEVE LEGISLATION IS NEEDED TO GIVE CREDIT UNION BOARDS OF DIRECTORS ADDITIONAL FLEXIBILITY TO MEET THE PARTICULAR INTERESTS OF THEIR MEMBERS. HOWEVER, BEFORE ADDRESSING THOSE AREAS, WE'D LIKE TO DISCUSS FIVE BROADER ISSUES AFFECTING FINANCIAL INSTITUTIONS GENERALLY.

INSURANCE

ON APRIL 15, 1983 THE NATIONAL CREDIT UNION ADMINISTRATION SUBMITTED ITS REPORT TO CONGRESS ON CREDIT UNION SHARE INSURANCE. THE DETAILED STUDY POINTS OUT THAT CREDIT UNIONS OPERATED FOR 36 YEARS, UNTIL 1971, WITHOUT ANY FEDERAL DEPOSIT INSURANCE. THE

OPPOSITION TO INSURANCE WAS BASED ON A FEELING THAT FEDERAL INSURANCE WAS NOT CONSISTENT WITH COOPERATIVE PRINCIPLES. DURING THIS 36-YEAR PERIOD, PRIVATE ALTERNATIVES WERE DEVELOPED AT THE STATE LEVEL. THESE ALTERNATIVE FUNDS OPERATE IN 34 STATES UNDER A VARIETY OF CAPITAL STRUCTURES, ASSESSMENT PRACTICES, COVERAGE LIMITS AND OPERATIONAL METHODS FOR MONITORING RISKS AND SOLVING PROBLEMS.

CUNA STRONGLY SUPPORTS THE NCUA POSITION IN ITS REPORT IN OPPOSITION TO CONSOLIDATION OF THE NCUA INSURANCE FUND WITH ANY OTHER INSURANCE FUND. CREDIT UNIONS ARE COOPERATIVES AND DISTINCT FROM OTHER INSURED STOCK AND MUTUAL FINANCIAL INSTITUTIONS. CUNA BELIEVES THAT CREDIT UNIONS AND THE NCUA HAVE DEVELOPED UNIQUE WAYS TO RESPOND TO FINANCIAL EMERGENCIES WHICH WOULD BE HINDERED OR ELIMINATED BY MERGER OR CONSOLIDATION WITH THE OTHER INSURANCE FUNDS. AS PART OF THE NCUA, THE SHARE INSURANCE FUND HAS THE ABILITY TO DRAW ON THE RESOURCES OF THE REGULATORY AGENCY AND TO ADAPT TO THE PECULIAR OPERATIONAL PRESSURES OF CREDIT UNIONS. AS PART OF A LARGER "SUPER FUND," THE INCENTIVE TO GRAPPLE WITH THESE UNIQUE PROBLEMS WOULD NOT BE PRESENT AND PRACTICES WHICH VARIED FROM THOSE OF OTHER INSTITUTIONS MIGHT BE STIFLED. INEVITABLY, AN UNDESIRED HOMOGENIZATION OF FINANCIAL

INSTITUTIONS WOULD OCCUR WERE INSURANCE RISK DEFINED BY ONE REGULATOR.

CUNA IS STUDYING THE OTHER MAJOR RECOMMENDATIONS OF THE NCUA INSURANCE STUDY. IN THE NEAR FUTURE OUR LEADERSHIP WILL CONSIDER THE DESIRABILITY OF OPTIONAL NON-FEDERAL INSURANCE FOR FEDERALLY CHARTERED CREDIT UNIONS, THE BEST METHOD FOR CAPITALIZING THE SHARE INSURANCE FUND AT AN APPROPRIATE LEVEL AND MAKE A FINAL RECOMMENDATION ON THE DESIRABILITY OF AN UNINSURED CAPITAL SHARE. ALL THESE WILL REQUIRE LEGISLATIVE RECOMMENDATIONS WHICH WE WILL BE PREPARED TO PRESENT TO CONGRESS AS OUR DELIBERATIONS ARE CONCLUDED.

BANKRUPTCY

CUNA CONTINUES TO CONSIDER THE REVISION OF THE BANKRUPTCY CODE OF 1978 A HIGH PRIORITY. ALTHOUGH THE SENATE HAS RECENTLY APPROVED TWO BANKRUPTCY REFORM BILLS, THE MATTER IS OF SUCH SIGNIFICANCE THAT WE BELIEVE IT WARRANTS A BRIEF DISCUSSION.

EVIDENCE IS GROWING THAT BECAUSE OF CONCERN OVER THE RISING NUMBER OF BANKRUPTCIES, CREDIT UNIONS HAVE ADJUSTED THEIR NORMAL LENDING PRACTICES. IN AN ERA OF INCREASED LIQUIDITY AND LOWERED COST OF FUNDS, CREDIT UNIONS ARE STILL RELUCTANT TO ENCOURAGE BORROWING BY THEIR ELIGIBLE MEMBERS BECAUSE OF THE INCREASED

POSSIBILITY OF LOSS DUE TO BANKRUPTCIES. IN ADDITION, THE RATES ON CONSUMER LOANS HAVE NOT FALLEN AS RAPIDLY AS OTHERWISE WOULD SEEM WARRANTED IN PART DUE TO THE INCREASED COSTS OCCASIONED BY BANKRUPTCY LOSSES. THE FINAL CHANGE IN CREDIT UNION LENDING PRACTICES HAS BEEN A GREATER RELIANCE ON SECURED LENDING, PARTICULARLY REAL ESTATE SECURED LENDING, AS AN AVENUE TO SOFTEN THE IMPACT OF THE EXISTING BANKRUPTCY LAW.

CUNA IS ENCOURAGED BY PASSAGE OF BANKRUPTCY LEGISLATION BY THE SENATE LAST WEEK, AND URGES THIS COMMITTEE TO DO WHAT IT CAN TO ENCOURAGE THE HOUSE TO ENACT SIMILAR MEASURES.

FEDERAL RESERVE BOARD REGULATIONS D, A, Z, E

THE EFFORTS OF THIS COMMITTEE HAVE SIGNIFICANTLY REDUCED THE BURDEN OF COMPLIANCE FOR SMALL INSTITUTIONS BY ACHIEVING GREATER FLEXIBILITY IN THE MONETARY CONTROL ACT THROUGH P.L. 97-320'S SMALL INSTITUTION EXEMPTION; THE REVISION OF REGULATION Z IN P.L. 96-221, WITH AMENDMENTS IN P.L. 97-320; AND THE FEDERAL RESERVE BOARD'S MODIFICATION OF THE REQUIREMENTS OF REGULATION E (ELECTRONIC FUNDS TRANSFERS) TO EXEMPT SMALL INSTITUTIONS FROM MANY REQUIREMENTS. THE EFFORT OF THE CONGRESS AND REGULATORY AGENCIES TO LESSEN THE BURDEN OF REGULATION IS GREATLY APPRECIATED.

SPECIAL PURPOSE SAVINGS INSTRUMENTS

For some time CUNA has supported special individual retirement accounts. In particular, we have called on Congress to authorize education and home-purchase IRAs.

Education costs continue to rise. The prospect of educating a child in the 1990s is terrifying to today's young parents. The severe financial strain which is destined to come is avoidable if parents are given the same attractive alternative to college education that is now available for retirement through the individual retirement account vehicle. We encourage this Committee to explore the possibility of IRAs for education and to work with the tax committees in securing legislation authorizing this type of investment vehicle.

Equally important in this economic environment is the fulfillment of the American promise of home ownership. A specialized tax-deferred account, designed to encourage home ownership, is a reasonable and convenient mechanism for accumulating the savings necessary to acquire a home.

We also think Congress should explore whether the tax treatment granted to people using IRAs equals tax benefits granted to other retirement savings programs established under the Internal Revenue Code, such as teacher annuity plans

(§ 403(B) PLANS) AND CASH OR DEFERRED ARRANGEMENTS (§ 401(K) PLANS). WE THINK CREDIT UNIONS SHOULD BE ABLE TO OFFER SAVINGS PROGRAMS WITH SIMILAR BENEFITS.

INSURANCE FOR INDIVIDUAL RETIREMENT ACCOUNTS

THE PRESENT $100,000 INSURANCE LIMITATION ON INDIVIDUAL RETIREMENT ACCOUNTS IS UNNECESSARILY LOW. INDIVIDUALS WHO ARE PLANNING FOR RETIREMENT, USING THE INDIVIDUAL RETIREMENT ACCOUNT VEHICLE, FREQUENTLY ACCUMULATE SUMS WHICH ARE LARGER THAN THE PRESENT INSURANCE LIMIT TO PROVIDE FOR THEIR RETIREMENT YEARS. WHEN PLACED IN A SINGLE ACCOUNT, THESE FUNDS ARE PARTIALLY UNINSURED. THE ANXIETY CAUSED BY HAVING TO SPLIT IRA INVESTMENTS TO ACHIEVE MAXIMUM INSURANCE COVERAGE OR ESTABLISH ACCOUNTS WHICH ARE PARTIALLY UNINSURED IS AVOIDABLE AND UNNECESSARY.

CUNA ENCOURAGES THIS COMMITTEE TO ESTABLISH HIGHER IRA COVERAGE LIMITS. IT IS OUR BELIEF THAT THE RISK INVOLVED IN INSURING LARGER AMOUNTS OF THESE RELATIVELY STABLE DEPOSITS IS MINIMAL. THEREFORE, THIS COMMITTEE IN CONJUNCTION WITH THE INSURING AGENCIES SHOULD BE ABLE TO ESTABLISH POLICIES WHICH PROVIDE FULL COVERAGE FOR ALL IRA DEPOSITS.

USURY

Federal credit unions lived under a 12% usury ceiling from 1934 until 1980. In 1979 the rapidly escalating cost of funds made the 12% limitation an anachronism which had the potential of shutting off credit union lending entirely. The 1980 legislation permitted a 15% rate and also permitted NCUA to exceed the 15% limit when conditions warranted a higher rate. Since December 1980, NCUA has had a 21% ceiling in effect. As we testified before this Committee in April, despite the 21% ceiling, the industry average has remained around 15%. However, some federal credit union programs, such as credit cards, need to charge a rate above the 15% set by statute.

This display of moderation in credit union lending experience is important not only because it shows a continuing dedication to providing credit to members at a reasonable cost, but also because it shows the relative lack of need for the restraining influence of an arbitrary usury ceiling. It is our belief that conditions justify further extension of the 21% ceiling beyond its expiration date in September of this year. However, a permanent solution--total deregulation of credit union lending--is far more desirable. The track record of credit unions shows that, if granted, it will not be abused.

MUTUAL FUND AND TRUST AUTHORITY

THE GARN-ST GERMAIN LEGISLATION MADE A NUMBER OF CHANGES IN THE FEDERAL CREDIT UNION ACT. ONE PROPOSAL WHICH WAS NOT ADOPTED THAT WE WOULD LIKE TO RENEW IS THE AUTHORITY TO OFFER MUTUAL FUNDS DIRECTLY OR THROUGH SUBSIDIARIES.

MUTUAL FUND AUTHORITY. IN 1981 CUNA SUGGESTED A LEGISLATIVE APPROACH WHICH WOULD ALLOW CREDIT UNIONS AND OTHER FINANCIAL INSTITUTIONS, THEIR HOLDING COMPANIES OR SERVICE CORPORATIONS TO OFFER MUTUAL FUND ACCOUNTS. IN ADDITION, THE LEGISLATION WOULD HAVE AUTHORIZED CREDIT UNIONS AND OTHERS TO OFFER THEIR MEMBERS EXISTING MUTUAL FUND ACCOUNTS THROUGH COOPERATIVE ARRANGEMENTS WITH A MERRILL LYNCH OR OTHER NONDEPOSITORY FINANCIAL INTERMEDIARY.

THE GARN-ST GERMAIN ACT AUTHORIZED A MONEY MARKET DEPOSIT ACCOUNT FOR CREDIT UNIONS AND OTHER DEPOSITORY FINANCIAL INSTITUTIONS. THIS SATISFIED THE IMMEDIATE NEED FOR A COMPETITIVE INSTRUMENT WHICH WAS NONRESERVABLE.

THE LONG-TERM SOLUTION PROPOSED BY CUNA IN 1981 ENVISIONS A SERIES OF COMPETITIVE INSTRUMENTS BEING DEVELOPED TO RESPOND TO VARIOUS MEMBER NEEDS FOR INCOME, LIQUIDITY OR TAX PLANNING. IT IS OUR BELIEF THAT THE PRESENT RESTRICTIONS PREVENTING CREDIT UNIONS AND OTHERS FROM SERVING EACH OF THESE NEEDS ARE UNNECES-

SARILY RESTRICTIVE. WE ENCOURAGE A PROMPT REVIEW BY CONGRESS OF ALL OF THE ISSUES RAISED BY THE RESTRICTIONS ON SECURITIES DEALINGS ON DEPOSITORY FINANCIAL INSTITUTIONS. WHILE WE BELIEVE THE LONG-TERM SOLUTION WE PROPOSED IN 1981 REMAINS VALID, CUNA IS PREPARED TO EXAMINE AND EXPLORE ANY OTHER ALTERNATIVES CONSIDERED BY THIS COMMITTEE.

COMMON TRUST AUTHORITY. CREDIT UNIONS HAVE ALWAYS SERVED THE FINANCIAL COUNSELLING ROLE ON BEHALF OF THEIR MEMBERS. THE EXERCISE OF COMMON TRUST AUTHORITY IS MERELY ONE OTHER ASPECT OF PROVIDING COMPLETE CONSUMER FINANCIAL SERVICES TO MEMBERS. WE BELIEVE THIS AUTHORITY IS CONSISTENT WITH THE CREDIT UNION CO-OPERATIVE SPIRIT AND THE EXISTENCE OF THE AUTHORITY WILL ENHANCE THE CREDIT UNION'S POSITION AS A PLACE FOR ITS MEMBERS' SAVINGS.

CREDIT UNION SERVICE ORGANIZATIONS

THE FEDERAL CREDIT UNION ACT AUTHORIZES CREDIT UNIONS TO INVEST IN SERVICE ORGANIZATIONS AND ALSO TO MAKE LOANS TO SERVICE ORGANIZATIONS. THE PRESENT STATUTORY LANGUAGE DISTINGUISHES BETWEEN THE AUTHORITY TO MAKE LOANS TO A SERVICE ORGANIZATION AND THE AUTHORITY TO INVEST IN A SERVICE ORGANIZATION. CUNA BELIEVES THE LANGUAGE FOUND IN 12 U.S.C. § 17575(D): "A CREDIT UNION

ORGANIZATION MEANS ANY ORGANIZATION, AS DETERMINED BY THE BOARD, WHICH IS ESTABLISHED PRIMARILY TO SERVE THE NEEDS OF ITS MEMBER CREDIT UNIONS, AND WHOSE BUSINESS RELATES TO THE DAILY OPERATIONS OF THE CREDIT UNIONS THEY SERVE," SHOULD BE AMENDED TO PARALLEL THE INVESTMENT LANGUAGE IN 12 U.S.C. § 1757(7). THUS, THE NEW LANGUAGE WOULD READ: "A CREDIT UNION ORGANIZATION MEANS ANY ORGANIZATION, AS DETERMINED BY THE BOARD, PROVIDING SERVICES WHICH ARE ASSOCIATED WITH THE ROUTINE OPERATIONS OF CREDIT UNIONS."

THE EXISTING STATUTORY LANGUAGE IS TROUBLESOME SOLELY BECAUSE OF ITS DIFFERENCE. THE NATIONAL CREDIT UNION ADMINISTRATION HAS NOT HAD DIFFICULTY INTERPRETING THE INTENT OF THE LANGUAGE. HOWEVER, IT APPEARS THAT THE CONGRESS DID NOT INTEND TO DISTINGUISH BETWEEN THE INVESTMENT AUTHORITY IN SERVICE ORGANIZATIONS AND THE LENDING AUTHORITY TO SERVICE ORGANIZATIONS. THEREFORE, THE TECHNICAL CHANGE MERELY ELIMINATES THE POTENTIAL FOR LATER INTERPRETIVE DIFFICULTY OR MISCONSTRUCTION.

CUNA ALSO URGES THAT THE 1% INVESTMENT LEEWAY PROVISION FOUND IN SECTION 1757(7) BE EXPANDED TO ALLOW CREDIT UNIONS MORE INVESTMENT FLEXIBILITY.

FEDERAL TRADE COMMISSION JURISDICTION

THE CREDIT UNION NATIONAL ASSOCIATION HAS SUPPORTED THE TRANSFER OF RESPONSIBILITY FOR UNFAIR AND DECEPTIVE ACTS OR PRACTICES OF FEDERAL CREDIT UNIONS TO THE NATIONAL CREDIT UNION ADMINISTRATION. THE FEDERAL TRADE COMMISSION CURRENTLY EXERCISES THIS AUTHORITY. IT IS THE ONLY INSTANCE IN WHICH THE FEDERAL TRADE COMMISSION HAS THIS TYPE OF JURISDICTION OVER FEDERAL CREDIT UNIONS. THIS LEADS TO REGULATORY OVERLAP AND AN UNNECESSARY COMPLIANCE BURDEN AS FEDERAL CREDIT UNIONS HAVE TO ADJUST TO ONE MORE REGULATORY AUTHORITY. THE PROPOSED CHANGE CURRENTLY BEING CONSIDERED BY CONGRESS WOULD CONFORM THE REGULATORY STRUCTURE TO THAT APPLICABLE TO OTHER LAWS, SUCH AS THE TRUTH-IN-LENDING ACT OR THE FAIR CREDIT BILLING ACT.

FOOD STAMP AUTHORITY

FEDERAL CREDIT UNIONS ARE NOT PRESENTLY PERMITTED TO ACT AS REDEMPTION AGENTS FOR FOOD STAMPS. IN A NUMBER OF AREAS THE USE OF FEDERAL CREDIT UNIONS WOULD BE MORE CONVENIENT THAN BANKS OR SAVINGS AND LOAN ASSOCIATIONS. THE REASONS CREDIT UNIONS HAVE NOT BEEN AUTHORIZED TO ACT AS FOOD STAMP REDEMPTION AGENTS ARE UNCLEAR. WE BELIEVE THAT PUBLIC POLICY SUPPORTS USE OF CREDIT UNIONS AS REDEMPTION AGENTS FOR FOOD STAMPS.

CREDIT UNION STAMP

FOR SOME TIME THE CREDIT UNION MOVEMENT HAS SOUGHT A STAMP COMMEMORATING THE ROLE OF CREDIT UNIONS IN THE DEVELOPMENT OF AMERICAN CONSUMERISM. WE BELIEVE THAT THE 50TH ANNIVERSARY OF THE FEDERAL CREDIT UNION ACT IS AN APPROPRIATE OCCASION FOR SUCH A STAMP. WE WOULD ASK THAT THE MEMBERS OF THIS COMMITTEE SUPPORT THE CREDIT UNION MOVEMENT IN ITS EFFORTS TO SECURE A SPECIAL STAMP COMMEMORATING THE ROLE OF FEDERAL CREDIT UNIONS IN AMERICA.

TAX-EXEMPT INCOME ACCOUNT

CUNA WOULD SUPPORT AUTHORITY THAT ALLOWS CREDIT UNIONS TO PASS ON THE TAX-EXEMPT NATURE OF INCOME FROM STATE AND LOCAL GOVERNMENT OBLIGATIONS WHICH THE CREDIT UNION PURCHASES THROUGH VARIOUS FINANCIAL ARRANGEMENTS, SUCH AS REPURCHASE AGREEMENTS. EARLIER, WE SUGGESTED THE NEED FOR MUTUAL FUND AUTHORITY WHICH WOULD ALLOW US TO CREATE TAX-EXEMPT SAVINGS VEHICLES IN ADDITION TO MARKET-RATE, INTEREST-SENSITIVE DEPOSIT INSTRUMENTS AUTHORIZED BY THE GARN-ST GERMAIN ACT. WE SEE NO REASON WHY A MEMBER SEEKING TAX-EXEMPT OR DEFERRED INCOME SHOULD BE RESTRICTED IN HIS SERVICE PROVIDORS TO MUTUAL FUNDS.

CONCLUSION

CUNA APPRECIATES THE OPPORTUNITY TO APPEAR AT THESE HEARINGS. IT IS OUR HOPE THAT THIS COMMITTEE'S TRACK RECORD IN THE 98TH CONGRESS IS AS PRODUCTIVE AS IT WAS IN THE 97TH. WE ENCOURAGE THIS COMMITTEE IN ITS WORK AND LOOK FORWARD TO ASSISTING YOU IN WHATEVER WAY POSSIBLE IN THE LEGISLATIVE PROCESS TO COME.

The CHAIRMAN. Thank you very much.
Mr. Hutchinson.

STATEMENT OF JOHN J. HUTCHINSON, PRESIDENT, NATIONAL ASSOCIATION OF FEDERAL CREDIT UNIONS

Mr. HUTCHINSON. Mr. Chairman and members of the committee, I appreciate the opportunity to appear before you today to discuss the current status of Federal credit unions and their role in the financial services industry of the future. I am John J. Hutchinson, president of the National Association of Federal Credit Unions and manager of Hamilton Standard Federal Credit Union, Windsor Locks, Conn. The National Association of Federal Credit Unions is the only national association exclusively representing the interests of federally chartered credit unions.

Two years ago I appeared before this committee with a list of recommendations and changes we advocated for Federal credit unions. Thanks in large part to the efforts of this committee, many of those suggestions have become reality. The amendments to the Federal Credit Union Act included in title V of the Garn-St Germain Act mean that now more than ever before Federal credit union officials are working within a structure that provides greater flexibility to meet the needs of the marketplace and the demands of our own members.

In addition, the commitment of the National Credit Union Administration to reduce the regulatory burden imposed on Federal credit unions means that once again the officials of Federal credit unions are better able to run their institutions as their members desire, not as mandated by Government regulation.

FEDERAL CREDIT UNIONS PROSPERING

We, in Federal credit unions, are proud to be the leaders in operating in a deregulated environment. We are also pleased to report that Federal credit unions are prospering under deregulation. NCUA statistics show that Federal credit unions were the fastest growing financial institutions during 1982, with assets increasing by 16 percent and savings growing by 17.2 percent. I believe that this growth, in large part, can be attributed to the positive aspects of deregulation, increased equality under expanded powers granted by Congress, and the ability of Federal credit unions to respond rapidly to the changing needs of their members.

These figures are particularly significant as Federal credit unions prepare to celebrate the 50th anniversary of the signing of the Federal Credit Union Act. Mr. Chairman, I would like to take this opportunity to thank you and Senator Proxmire for introducing Senate Joint Resolution 84, which would designate June 24–30, 1984, as Federal Credit Union Week. I am proud to say that after 50 years of serving the financial needs of American consumers, credit unions remain true to the philosophy and purpose for which they were created. In the forefront of that effort the volunteer, cooperative foundation continues to thrive.

The expansion of credit union powers that we have seen in recent years has allowed Federal credit unions to continue to operate safely as well as soundly and to meet their members' needs, while retaining their unique identity. Therefore, Mr. Chairman, while there remains some unfinished credit union business before Congress, we are not here to ask for any broad legislative changes in Federal credit union powers. We feel Federal credit unions are well-positioned to continue the important role they play in the financial services industry. I would, however, like to address some current issues pending before this committee and the recent studies completed by the NCUA.

Recently, this Committee held hearings on S. 730, a bill dealing with consumer usury ceilings. We strongly support section IV of that bill, which would abolish the Federal usury ceiling imposed on Federal credit unions and thereby permit the boards of directors of Federal credit unions to be responsible and accountable for setting their own loan rates. Credit union officials now have that flexibility in determining rates on savings and should have parallel authority to determine loan rates. I hope that the committee will be able to take positive action on this legislation in the near future. We also reiterate our position that Federal credit unions should be removed from the jurisdiction of the Federal Trade Commission, just as all other financial institutions now are.

The Garn-St Germain Act required two specific studies from the NCUA. I would first like to address the study regarding compensation of Federal credit union directors. Soon after the Garn-St Germain Act was passed, we surveyed our membership regarding their opinions on compensation of directors. More than 82 percent of the respondents said that they did not want to see a change in current policy. We then communicated this information to NCUA, who—we are pleased to note—recommended to Congress that the current policy prohibiting compensation be continued. NAFCU wholeheartedly supports that recommendation. Therefore, I hope that Congress determines there is no need to change that policy and will continue the tradition of volunteer service that is the backbone of Federal credit unions.

The NCUA also submitted a study to Congress regarding the National Credit Union Share Insurance Fund. My written statement addresses the specifics of their recommendations. Therefore, at this time I would like to say only that we believe the current system of Federal share insurance works and is beneficial to the 26 million Federal credit union members in this country. While we continue to explore possible changes that might improve on the current system, we must disagree with NCUA's opinion that private insurers should be given the option of providing this coverage. As long as coverage is mandatory, we feel that all involved are better served by a Federal plan available to all under the same costs and regulations. To do otherwise would make the National Credit Union Share Insurance Fund an insurer of last resort. We strongly believe that the NCUSIF should remain separate from other deposit insurance corporations.

Mr. Chairman, the National Association of Federal Credit Unions feels strongly that Federal credit unions today are well-situated to serve the various financial needs of their consumer-members. While there have been some problems within the industry, our regulatory structure has proven able to respond quickly and efficiently. The structure and powers under which Federal credit unions now operate provide wide latitude to meet the changes of a dynamic economy. We feel certain this has been the intent of Congress in the past and will continue to be in the future.

Thank you. I will be happy to respond to any questions you may have.

[Complete statement follows:]

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TESTIMONY OF JOHN J. HUTCHINSON

PRESIDENT OF

THE NATIONAL ASSOCIATION OF FEDERAL CREDIT UNIONS

INTRODUCTION

Mr. Chairman and members of the Committee, it is a pleasure for me to appear before you this morning as you review the status and future of the financial services industry. I am John J. Hutchinson, president of the National Association of Federal Credit Unions (NAFCU), and manager of Hamilton Standard Federal Credit Union in Windsor Locks, Connecticut. The National Association of Federal Credit Unions (NAFCU) is the only national organization exclusively representing the interests of credit unions chartered by the federal government. There are approximately 11,400 Federal credit unions throughout the country representing more than 26 million consumer members.

The issues raised by these hearings are important not only to every segment of the financial services industry, but also to the consumers they serve. The National Association of Federal Credit Unions (NAFCU) has played a major role in the development of the legislative and regulatory environment in which Federal credit unions currently operate. We pledge our continued cooperation as you examine the present condition of the financial services industry and consider policy options for the future.

FIFTY YEARS OF DEDICATED SERVICE

I would like to take this opportunity, Mr. Chairman, to thank you and Senator Proxmire for recently introducing Senate Joint Resolution (S. J. Res.) 64. I would also like to express sincere appreciation to those Senators who have joined with you in cosponsoring this resolution which recognizes the fifty years of dedicated service Federal credit unions have provided. As you remarked when introducing S. J. Res. 84, "Recent marketplace and legislative changes have caused a blurring of some of the traditional distinctions among different types of financial organizations, but Federal credit unions remain cooperative, not-for-profit institutions." That is one of the issues I would like to discuss today.

UNIQUE CHARACTERISTICS DISTINGUISH CREDIT UNIONS

During the present period of rapid change in the financial marketplace, it has become popular to view all regulated depository institutions in the same light. However, credit unions are not "public" institutions; in fact, a credit union's limited field of membership establishes a clear difference between credit unions and other financial institutions which serve the general public.

CREDIT UNION ORGANIZATION IS DIFFERENT

Credit unions, unlike other financial institutions, are truly cooperative organizations in philosophy, organization and operation. A credit union is formed by a group of persons usually because the existing structure of financial services has failed to provide for their needs. The fundamental purposes of a credit union still remain to encourage thrift, to provide a source of low-cost consumer credit, and to promote prudent financial management among its members.

In a Federal credit union, the members manage the operations through the democratic process. Each member has one vote, regardless of the number of dollars held or the amount of loans owed. Because the philosophy of the credit union is one of self-help, the operations of most credit unions rely almost completely on volunteerism and all Federal credit unions have a volunteer board of directors. A credit union may not compensate its board members, nor may it compensate its supervisory and credit committee members. Thus, a credit union has no entrepreneurial management or ownership.

The credit union is the sum of its members who cooperatively provide sound financial management of their own funds. A credit union's operating policies are determined democratically by its members who are its borrowers, its savers, its owners and its benefactors.

CREDIT UNIONS AS CONSUMER COOPERATIVES

Credit unions have historically been in the forefront of regulatory changes aimed at benefiting consumers. For example, the National Association of Federal Credit Unions, in countless appearances before this and other Congressional Committees in the 96th and 97th Congresses, repeatedly advocated the total deregulation of credit union share accounts. I am pleased to report that by cooperatively working with our agency, NAFCU's efforts uitimately met with success when on April 22, 1982 the National Credit Union Administration Board promulgated a final rule totally deregulating the rate that credit unions may pay on credit union shares.

The members of this Association are proud of the leadership role credit unions have taken in guaranteeing that savers realize the highest possible rate of return available in a highly competitive financial marketplace.

THE CREDIT UNION COMMON BOND

Each credit union serves a membership limited to a common bond of occupation, association or, in some cases, local residence. Other financial institutions are open to the general public for both deposit and lending activities, and may make loans to non-depositors. However, credit union membership is not open to the general public, and credit unions may make loans only to their members. This limitation is imposed by Section 109 of the Federal Credit Union Act (12 U.S.C. 1759).

I do not know how many members of the Committee are members of the

United States Senate Employees Federal Credit Union. However, I do know that you are all eligible to belong to that credit union because you fall within the "common bond" of people who the credit union is chartered to serve. Yet, there are many people who live on Capitol Hill, and others who visit the Capitol buildings daily, who are not eligible to belong to U.S. Senate Employees Federal Credit Union because they are not members of the Senate or its employees. As you can see, the common bond limitation effectively inhibits the growth of credit unions and prevents credit unions from competing directly with other financial institutions.

CREDIT UNION SIZE

Although the growth of credit unions has been substantial over the past decade, the overwhelming majority of credit unions remain quite small. The small size of most credit unions results from the limitations that necessarily flow from the common bond.

As of December 31, 1982 there were 11,430 Federal credit unions. Of this number....

8,220 or 71.9% had assets of less than $2 Million
9,777 or 85.5% had assets of less than $5 Million
10,521 or 92.0% had assets of less than $10 Million
10,968 or 96.0% had assets of less than $20 Million
11,273 or 98.6% had assets of less than $50 Million

Thus, large credit unions, although commonly cited by critics as examples of "typical" credit unions, are clearly exceptions. They represent large numbers of members, but they do not represent the majority of the credit unions. I hasten to add, however, that larger credit unions do reflect the financial needs of their members, and their philosophy and structure are no different from that of other credit unions. They have traditionally served the needs of all who sought their services and have not limited the credit union's services to special interest groups.

While there are many credit unions, they hold only 4.6% of all consumer deposits in regulated depository institutions. The facts reveal that the vast majority of credit unions are so small that many credit unions operate with fewer assets than the minimum necessary to charter a bank or a savings and loan association. In almost every case, these small credit unions provide financial services not available elsewhere to consumers.

SELF SUPPORTIVE NATURE OF CREDIT UNIONS

The bulk of work done at credit unions is carried out by volunteers. This operational distinction is one of the many factors that makes credit unions different from other financial institutions. Volunteerism is a basic element of the credit union philosophy. It is estimated that there are more than 200,000 people in this country serving as volunteers at Federal credit unions. They serve as board members, committee members and in many cases run the day to day operations of the credit union. These people are the backbone of the credit union industry.

CREDIT UNIONS REMAIN DIFFERENT FROM OTHER FINANCIAL INSTITUTIONS DESPITE RECENT EXPANDED POWERS

In recent years credit unions have been authorized by Congress to offer their members a number of additional services. I would like to address that point, because some have said that these new powers have made credit unions "functionally identical" to other financial institutions.

Even though credit unions are now able to provide many of the same kinds of services as other institutions, such as residential mortgages, lines of credit, and credit cards, they were authorized to do so only because their members had needs that other financial organizations were not adequately fulfilling. These expanded powers are used differently by credit unions, depending on their size, sophistication and the needs of their members. As in all other services, it is up to the credit union's board of directors to determine which services will be offered by the credit union for the benefit of its members.

It is important to recognize that each of the various types of financial institutions performs a specific function in order to meet particular credit needs within the financial marketplace. Although some activities do overlap, the primary functions of each institution remain different. The purpose of credit unions is to promote thrift and provide credit to individuals within a very well-defined field of membership. The recently expanded powers of credit unions relate almost exclusively to the types of services which may enhance the capacity of credit unions to meet those needs, and thereby comply with their statutory mandate.

As our country grows and expands into new methods of financial management credit unions also must be able to meet those changes and keep providing their services in the manner that has made them unique. Recent legislative enactments have been designed to provide credit unions with the necessary tools to creatively meet their members' needs, while retaining their unique identity as credit unions.

As the 50th anniversary of the signing of the Federal Credit Union Act approaches, we find ourselves pausing to reflect upon our first 50 years, and to renew our commitment to the unique role Federal credit unions will play in providing consumer financial services during the next 50 years.

CREDIT UNION BOARD MEMBERS SHOULD SERVE WITHOUT COMPENSATION

Section 533 of the Garn-St Germain Depository Institutions Act of 1982 (P.L. 97-320) required the National Credit Union Administration Board to conduct a study to determine the feasibility and desirability of permitting Federal credit unions to compensate members of their boards of directors. In accordance with Section 533 of Public Law 97-320, NCUA transmitted their study and recommendations on the subject of directors' compensation on April 15. The NCUA study stated that, "any action to relax present law concerning directors' compensation would be inadvisable, and the Board strongly recommends against such action at this time." The National Association of Federal Credit Unions (NAFCU) fully concurs.

In late December 1982, NAFCU surveyed its membership on the issue of Directors' Compensation. The survey clearly indicated a lack of enthusiasm for compensation of directors, with more than 82% of the respondents stating that they opposed compensation or had no opinion on the issue. Only 16% of those responding felt that compensation would lead to a change in the board of directors that would be beneficial for the credit union.

Compensation of directors would indicate a fundamental shift in the philosophy governing credit unions. It is a change that neither the Association nor its members feel would be in the best interest of the credit union industry.

Mr. Chairman, most of the volunteers whom I come in contact with are dedicated, hard-working individuals committed to serving the interest of their fellow credit union members. They have, for 50 years, been willing to do that not for compensation, but for the higher reward of knowing that they are helping people.

NATIONAL CREDIT UNION SHARE INSURANCE FUND

In addition to studying the question of compensation for credit union board members, the Garn-St Germain Act instructed NCUA, as well as the Federal Deposit Insurance Corporation (FDIC) and the Federal Savings and Loan

Insurance Corporation (FSLIC) to conduct separate studies addressing a number of questions concerning their respective insurance funds. In accordance with Section 712 of Public Law 97-320, these reports were, I understand, transmitted to the Chairmen of the House and Senate Banking Committees on April 15.

Before presenting NAFCU's specific recommendations on this subject, I would like to provide the Committee members with a brief history of the National Credit Union Share Insurance Fund (NCUSIF). A more thorough history, as related in the current issue of The Federal Credit Union, an official publication of the National Association of Federal Credit Unions, is attached as Appendix I.

NAFCU played an instrumental role in the creation of Federal share insurance for Federal credit unions. It was an issue that drew together credit unions in the late 1960's; an issue which they fought vehemently for and were successful in attaining. Establishment of the National Credit Union Share Insurance Fund (NCUSIF) was one of the first major legislative victories for the then newly created National Association of Federal Credit Unions.

Therefore, Mr. Chairman, when the Garn-St Germain Act mandated a study of Federal share insurance, we went directly to our membership to find out what they wanted. A survey sent out in late December, 1982, revealed that NAFCU member credit unions are, overall, happy with the current system of Federal share insurance. To the question, "Does the current share insurance system adequately serve the needs of your credit union?" only 11% expressed a negative response. Therefore, we believe that the present share insurance system meets the current needs of Federal credit unions. NAFCU strongly opposes the consolidation of the share insurance fund with any other deposit insurance fund.

We are aware that the NCUA has proposed that Federal credit unions be provided the opportunity to purchase insurance for shares from other than the National Credit Union Share Insurance Fund. They believe that the private insurance option should be made available to Federal credit unions, and that the National Credit Union Share Insurance Fund (NCUSIF) become, in effect, an insurer of last resort.

Many times NAFCU has appeared before this Committee in support of providing as much latitude and as many options as possible to the Boards of Directors of Federal credit unions. However, in this case we cannot agree with the National Credit Union Administration that providing an option in the case of share insurance is in the best interest of credit union members. As depositories for the savings of our members, it is essential that they know their funds are safe. That assurance has been provided through Federal share insurance. We question whether establishment of a private insurer of Federal credit union member share accounts would be in the best interest of the 26 million Federal credit union members. Furthermore, we question whether indeed the concept of the share insurance fund as an insurer of last resort is a viable and preferable policy. Mr. Chairman, it seems to me that to insure only those Federal credit unions that cannot qualify for insurance in the private market would create an unworkable competitive division between the private marketplace and the government sector. I believe it is a concept that simply cannot work for Federal credit unions.

We have not, however, totally closed the door to considering the use of private insurance. In fact, the Association supports the idea of an option of insuring accounts above $100,000 on a voluntary basis through private companies or state guarantee corporations. The area in which our members have shown the most interest in this concept is the insurance of IRA accounts above $100,000.

The NCUA insurance study also addressed the issue of basing insurance premiums on risk of the institution to the insurance fund. NCUA opposed this concept, and NAFCU too rejects it as a way of determining insurance premiums for share accounts. We simply do not believe that a risk-based premium would work in a government related fund that is mandatory.

Mr. Chairman, we are studying in detail the current status of the share insurance fund, since -- as I am sure you are aware -- our members will pay two premiums this year and paid an extra assessment last year. We believe that Federal credit unions are committed to their own insurance fund and making sure that it is adequate to meet any demands placed upon it by credit unions. NAFCU believes that a strong Federal share insurance fund exclusively for Federal credit unions and state-chartered credit unions that choose to use it, is essential.

PRESERVE A SEPARATE CREDIT UNION REGULATORY AGENCY

Earlier in this statement I described some of the unique characteristics that distinguish credit unions from other providers of consumer financial services. NAFCU will vigorously oppose any efforts to diminish, dismantle or abolish the National Credit Union Administration's scope of authority.

Since the signing of the Federal Credit Union Act, credit unions have worked diligently to establish their own identity. The Federal Credit Union Act of 1934 placed the supervisory authority over Federal credit unions within the Farm Credit Administration. Federal credit unions remained under the jurisdiction of the Farm Credit Administration until 1942, when regulatory authority over Federal credit unions was transferred to the Federal Deposit Insurance Corporation.

This transfer of credit union regulatory authority continued until 1948, when the FDIC was faced with the need to request appropriations for its credit union responsibilities. Rather than enter the appropriations process, the then Bureau of Federal Credit Unions was transferred to the Federal Security Agency, the predecessor to the Social Security Administration.

Five years later, in 1953, the Federal Security Agency was abolished. At that time the Bureau of Federal Credit Unions, together with other agencies of the Federal Security Agency, was transferred to the Department of Health, Education and Welfare.

On March 10, 1970, President Nixon signed into law Public Law 91-206, a measure strongly endorsed and actively supported by this Association. At last, Federal credit unions could look forward to a regulator who understood the uniqueness of credit unions since Public Law 91-206 created the National Credit Union Administration as an independent agency and transferred all of the functions of the Bureau of Federal Credit Unions to the new Administration. Later in 1970, thanks to the hard work of this Association, Public Law 91-468 (October 19, 1970) gave an additional responsibility to the new agency: the administration of the National Credit Union Share Insurance Fund. On November 10, 1978, President Carter signed Public Law 95-630. This measure, again with NAFCU's endorsement, resulted in the restructuring of the National Credit Union Administration from an agency headed by a single Administrator to the agency we know today, comprised of a three-member board.

Mr. Chairman and members of the Committee, Federal credit unions are just now emerging from a 50 year regulatory odyssey. I suggest that to alter the credit union regulatory structure at this time would remove its independence, and negate the volunteerism which has been its greatest strength.

NAFCU believes that the regulatory framework under which Federal credit unions operate is not overly burdensome, complex or confusing. Unlike other financial institutions, Federal credit unions deal primarily with one agency.

NAFCU has found the officials of the National Credit Union Administration to be open to new ideas, committed to deregulation and generally effective in handling supervisory problems. It is an agency that, because of its focus on Federal credit unions, is able to respond quickly and effectively to the needs of the Federal credit unions it regulates.

While there is always room for improvement, we believe at this time that the regulatory structure of Federal credit unions is effective from the standpoint of both the regulatory agency and the Federal credit unions it oversees. We are firmly convinced that the inclusion of Federal credit unions in a single "Super Agency" would not serve the best interests of Federal credit unions or their member-owners, and would indicate a lack of understanding of the unique characteristics of credit unions and how credit unions actually function. Credit unions have been and remain self-supporting, using no tax dollars, which differentiates them from other federal agencies.

FEDERAL CREDIT UNIONS ARE NOT BANKS

Section 101 of the Federal Credit Union Act (12 U.S.C. 1752(1)) defines the term "Federal credit union" to mean:

> a cooperative association organized in accordance with the provisions of this chapter for the purpose of promoting thrift among its members and creating a source of credit for provident or productive purposes...

The preamble to that Act further clarifies that the purpose of a Federal credit union is:

> to make more available to people of small means credit for provident purposes through a national system of cooperative credit, thereby helping to stablize the credit structure of the United States.

Those brief lines indicate much more than the mere purpose served by Federal credit unions; they also reveal the underlying principles and values which have been extolled by Federal credit unions for almost 50 years. Recently, the Chairman of the Federal Deposit Insurance Corporation suggested that "It may be appropriate to redefine a 'bank' as 'any institution that offers any type of federally insured deposit'."

While I do not challenge Chairman Isaac's view that the time has arrived for the Congress to reconsider the proper definition of the term "bank," I would like to state unequivocally that any definition of the term "bank" which uses as its determining factor the offering of "any types of federally insured deposit" would be unacceptable to this Association. Why? Because such a redefinition could lump Federal credit unions in the same category as banks with no apparent regard being given to the purpose, principles and values embraced by our nation's Federal credit unions.

THE MANNER OF DETERMINING FEDERAL CREDIT UNION LOAN RATES

Enactment of the Garn-St Germain Act last year was certainly a milestone in the development of the Federal Credit Union Act. As I noted earlier, one common theme running through the credit union amendments contained in Title V of the Garn-St Germain Act is this: the responsibility for making decisions affecting the day-to-day operations of our nation's credit unions should be placed in the hands of credit union professionals, unhampered by superfluous government regulation.

NAFCU has traditionally opposed all ceilings and floors set on the cost of funds. We feel our position on usury ceilings has been made clear on several occasions in testimony before this Committee. NAFCU members have consistently reaffirmed their long standing position that the marketplace, unhampered by government regulation, should establish the rate charged on loans, as well as dividends paid to savers.

Thanks to the hard work of you and your colleagues in the Senate and the House, the Garn-St Germain bill was enacted into law last year. This bill was a major step toward allowing the board of directors of a Federal credit union to set policies governing their individual institutions. It is our belief that the boards of directors have used this new authority in a prudent and sensible manner. In keeping with the theme of deregulation set forth by the Garn-St Germain Act, NAFCU believes that Federal credit unions should be permitted to determine what loan rates they should charge their members, without the imposition of an artificial ceiling.

Mr. Chairman, as you mentioned in your floor statement when introducing S. 730, Federal credit unions are the only class of financial institutions governed by a federal consumer usury ceiling. We strongly support Section 4 of S. 730 which would abolish this ceiling and, therefore, permit the boards of directors of Federal credit unions to be responsible and accountable for setting their own loan rates.

WITHHOLDING OF TAXES ON INTEREST AND DIVIDENDS

Over the course of the past many months numerous claims and counter-claims have been made regarding the level of taxpayer compliance with provisions contained in the Internal Revenue Code requiring the payment of federal income tax on interest and dividend receipts. Misinformation and irresponsible charges were made by individuals on various sides of this issue.

The Senate has expressed its will on this matter by a vote of 91 to 5. We accept the responsible alternative compromise recently agreed to by the Senate. I would like to thank the members of the Committee and your colleagues who facilitated the development of the Dole-Kasten withholding substitute.

PERMANENT ROLE FOR FEDERAL CREDIT UNIONS

It is important to recognize that each of the various types of financial institutions performs a specific function in order to meet particular thrift and credit needs within the financial marketplace. Although some activities do overlap, the primary functions of each institution have been and remain different. The purpose of credit unions is to promote thrift and provide credit to individuals within a specific field of membership. The recently expanded powers of credit unions relate almost exclusively to the types of services which may enhance the capacity of credit unions to meet those needs, and thereby comply with their statutory mandate.

As our country grows and expands into new methods of financial management credit unions also must be able to meet those changes and keep providing the services in the manner that has made them unique. The members of the National Association of Federal Credit Unions (NAFCU) are proud of the role Federal credit unions have played during their first 50 years of service, and look forward with confidence to the challenges of the next 50 years.

There is a permanent role for Federal credit unions in the financial marketplace of the future, and NAFCU pledges to work with you in planning for that future while diligently defending those unique qualities which distinguish Federal credit unions from other financial institutions.

CONCLUSION

Mr. Chairman, this concludes my prepared statement. I have attached in Appendix II a brief list of issues which NAFCU believes merit Congressional review. I would be pleased to expand upon those items or respond to any questions members of the Committee might have at this time.

APPENDIX I

CU share insurance:

FEDERAL CREDIT UNIONS
1934-1984

Federal share insurance for credit unions grew out of a need to retain and increase member shares by providing the same deposit security offered by other financial institutions. Since 1970, when Public Law 91-468 made way for the organization of the National Credit Union Share Insurance Fund (NCUSIF), credit unions have continued to grow in size and stature in the financial community.

But with the passage of the Garn-St Germain Act of 1982, which requires a study on the financial industry's three deposit insurance funds, questions about the share insurance fund have been raised. According to the law, reports on the funds must be made by the Federal Deposit Insurance Corporation (FDIC), the Federal Savings and Loan Insurance Corporation (FSLIC) and the National Credit Union Administration (NCUA). These reports must examine the current systems of deposit insurance and their development, as well as the feasibility of purchasing additional private coverage, adjusting the level of government insurance coverage, basing insurance premiums on risk, and consolidating the three separate insurance funds.

The insurance study is "a matter which will substantially affect the future of credit union insurance, regulation and supervision," said NCUA Board Chairman Edgar Callahan in a letter to NAFCU requesting input on this issue. The historical information that NCUA supplies to Congress on the current system of credit union deposit insurance will be crucial in preventing consolidation of the NCUSIF with the FDIC and the FSLIC, according to NCUA.

As NAFCU Executive Vice President Mal Nestlerode said in his reply to Callahan's request, "the growth and success of Federal credit unions in the last decade is due in large part to the existence of government insurance for member shares." Federal credit unions are unique, Nestlerode said. "Their needs and problems are so different from those of the banking community that it is essential that we keep an insurance fund which can quickly and effectively respond to [their] special needs."

History of share insurance
While banks and savings and loans have been operating with deposit insurance since the 1930s, credit union shares have been insured only for the past 13 years. The events that led to the development of share insurance have made the current operation of the NCUSIF distinctly different from other insurance funds.

The 1950s and 1960s were years of tremendous growth and expansion for credit unions. Larger credit unions were updating their operations through the use of modern management techniques and computer technology. As these credit unions became more competitive with other types of financial institutions, they discovered the need for legislative changes that would allow them to better serve their memberships.

Although the growth of credit unions during this period was significant, so was the number of liquidations. Most of the liquidations were of small occupational credit unions, however, and resulted from the closing of plants or from insufficient membership. Through cooperation within the industry, net losses to members were kept to a minimum. Yet federal share insurance still was needed to offer credit union members security on their savings comparable to that offered by other financial institutions.

The leadership of the organized credit union movement, citing the excellent safety record of credit unions, had successfully opposed the introduction of a share insurance system. They argued that such a program would mean increased costs, additional paperwork and government interference, and would make it more difficult for new credit unions to be chartered.

Because of this resistance, a number of the larger credit unions joined together and in 1967 formed NAFCU. This association would provide Federal credit unions with the legislative representation they needed to obtain results on issues such as federal share insurance.

In May 1970, Sen. Wallace F. Bennett (R-UT) introduced a bill to create federal share insurance for all Federal credit unions and for state-chartered credit unions on an elective basis. During hearings on the legislation in June of that year, NAFCU President Mack Rogers rebutted many of the arguments that had been made against share insurance. He said that credit unions' excellent safety record was "not good enough" if financial losses in credit unions caused any amount of hardship and loss of confidence on the part of individual members.

Rogers pointed out that the cost of an insurance premium "would not constitute an unreasonable burden on a credit union of any size," and the advantages of fed-

Is it still unique?

eral share insurance would far outweigh the disadvantages of added expense and paperwork. He also noted that "there could possibly be a review of chartering standards as a result of the enactment of a share insurance law," but that higher standards would likely contribute to the overall strength of the industry. The majority of credit union members, Rogers added, already believed that their savings were insured. It was important, therefore, to provide the coverage to meet their expectations.

On October 19, 1970, Bennett's bill was signed into law, and the credit union industry finally had its federal share insurance program. Since that time, the NCUSIF has served to solidify the credit union industry without detriment to the philosophy, independence or financial health of credit unions. In Nestlerode's reply to NCUA, he noted that, because of share insurance, the loss of savings has been eliminated, member confidence has increased dramatically and credit unions' growth has been outstanding.

Operation of the NCUSIF

Those who advocate consolidation of the three deposit insurance funds suggest that the result might be lower premiums and a streamlined, government-backed insurance program. But such an argument ignores the unique qualities of the NCUSIF, said Nestlerode. While the primary purpose of share insurance is to insure member shares, the NCUSIF also was designed to give NCUA additional resources for resolving financial and operating problems in insured credit unions. In this capacity, the fund is very different from the FDIC and the FSLIC.

From NCUA's regular examinations of credit unions, its staff can determine when credit unions are in trouble and provide the necessary short-term financial assistance to prevent liquidations. "We believe that insurance is an extension of supervision, an integral part of the problem-solving range of tools available for the agency, not a separate entity to which problems are turned over when supervision declares an institution cannot be saved," said Charles Filson, chief executive officer of the NCUSIF.

Industry officials fear that this specialized interaction between the regulatory agency and credit unions could not be maintained if there were no separate insurance fund. "For example," said Nestlerode, "some of the problems credit unions face relate directly to the economic problems of their sponsor companies; through the share insurance fund, assistance is often able to be provided on a short-term basis. We do not see that a single insurance fund would be able to understand and adequately address these economic needs of Federal credit unions."

The NCUSIF's assistance to troubled credit unions takes different forms, and it is up to the NCUA examiners to determine the most appropriate type of aid. NCUA is authorized to take supervisory action, and may waive a credit union's reserve requirements for a period of time. The NCUSIF also may provide non-cash guarantee assistance, or cash assistance in the form of loans, share deposits or the purchase of a credit union's assets.

If financial assistance is not enough, NCUA will try to find a merger partner for an ailing credit union. It is only when merger efforts fail that the agency will move to liquidate. At that point, the NCUSIF assumes management of the credit union's assets (through the sale of loan portfolios) and recoveries from liquidation.

Industry support

Unlike the other insurance funds, the NCUSIF received no seed capital from the government. Initially, credit union insurance premiums were its only source of income and were set at 1/12 of 1 percent of shares.

Last year, NCUA assessed a special premium of 1/18 of 1 percent, which brought in almost $34 million to the insurance fund. This amount helped to offset the additional costs incurred in recent years from an increase in credit union merger and liquidation activity and an increase in financial assistance to troubled institutions. Another special assessment is expected this year to keep the fund's equity at a stable level.

"The credit union movement demonstrated a willingness to address its own problems when it supported the effort to increase the size of the NCUSIF with an additional premium assessment," said Nestlerode in his letter to Callahan. "We encourage NCUA to emphasize in its study to Congress that credit unions are capable of acting responsibly in recognizing the need for a strong Federal credit union share insurance fund."

If the federal deposit insurance funds were to be consolidated, said Filson, "nothing less than the future of the credit union movement could be at risk." He emphasized that the credit union industry's insurance experience has been vastly different from that of banks or thrift institutions.

"It is important, if not imperative, that we look at future needs and developments from the viewpoint of credit unions," he said. "We need to develop a . . . framework of insurance that will let credit unions be credit unions. —D.L.

APPENDIX II

A. Bankruptcy Reform

Last week the Senate passed S. 445, the consumer bankruptcy reform amendments. We feel this is a positive step towards improving in the 1978 Bankruptcy Law. Enactment of this bill into law will enable credit unions to provide services to their members at more reasonable rates.

B. Exemption From Federal Trade Commission Jurisdiction

This Association believes that having the Federal Trade Commission (FTC) and the National Credit Union Administration promulgate regulations regarding Federal credit unions is a duplication of effort. We feel the NCUA Board has the expertise to regulate Federal credit unions and it would be less costly and more efficient to exempt federally chartered credit unions from FTC jurisdiction.

C. Regulation D

It never was the intent or purpose of the Federal Reserve System to be in a profit making business. Yet each year the Federal Reserve turns over billions of dollars to the United States Treasury. Many question the need for these reserves in determining monetary policy. In any event, if reserves continue to be required, at the very least interest should be paid on them.

D. CLF Tax Exemption

We agree with the National Credit Union Administration that the CLF has not obtained tax exempt status due to an oversight in the enactment of Title XVIII of P.L. 95-630. Given the tax-exempt status of credit unions, we believe it is only logical that the CLF be afforded the same status as the institutions it helps to meet their liquidity needs.

E. Individual Retirement Accounts

There are some changes that can be made in the existing IRA law that we feel will make IRAs more attractive as a savings and investment instrument. Those changes include:

1) Increasing the limit on deductable contributions;

2) Permitting non-deductible contributions;

3) Permitting limited withdrawals for the purpose of making a down payment on a first home or to meet higher education expenses for dependents.

F. Credit Union Seat On Boards Of Federal Reserve Regional Banks

There are now three different classifications of members on boards of the regional banks. We feel that since many credit unions are required to post reserves with the Fed under Reg D they should be adequately represented on these boards.

The CHAIRMAN. Mr. Hutchinson, as credit unions grow and tend to get larger, many of them very large, how do you continue to maintain the character of a credit union with the level of personal service, the informality that has existed, and the relationship with your shareholders, in a very, very large organization in some cases?

Mr. HUTCHINSON. That's a good question. I think the fact that we have maintained the volunteer as the basis of our board of directors and our committee structures has been essential. It demonstrates the strong contacts credit unions have directly with the membership. The fact that the directors are elected from the membership by the membership assures that they do maintain control of the credit union on an ongoing basis.

The desire of the credit union to serve the consumers' needs has remained constant. The things that have changed have been the methodology and the technological aspects of computer bookkeeping, for instance. But the basics of the credit union have not changed today from what they were when the act was first signed. So I think that the warm, open-door policy that credit unions have always had remains and the primary element of that is that volunteer effort.

CREDIT UNION VERSUS MUTUAL SAVINGS BANK

The CHAIRMAN. Mr. Cugini, how does a $500 million credit union differ from a $500 million mutual savings bank?

Mr. CUGINI. Well, Mr. Chairman, I still believe that the differences between those two institutions can't be seen by comparing the services that those two institutions provide to their customers or members. Services do not really reflect what the credit union is, structure does. The credit union is member owned. It is still run on the principle that each member has one vote. It's a mutually owned cooperative. And I think those are the very distinctions that we constantly work at preserving. Credit unions try to get big without getting bigoted. The people we serve are our owners and as long as they are our owners you're to do everything you can to satisfy them.

The CHAIRMAN. Getting back to what you were saying, Mr. Hutchinson, about your elected board of directors, the Garn-St Germain Act last year asked NCUA to study whether or not you should be given the authority to pay or compensate directors.

What's the basis for your organization's opposition to any compensation to your directors?

Mr. HUTCHINSON. Well, as I mentioned in my testimony, we did survey our membership on that particular question. The answer we got back from the membership is that they were strongly opposed to changing the present structure which is a nonpaid director. We stand by that position.

The CHAIRMAN. Do you provide your members or your board necessary travel or other expenses?

Mr. HUTCHINSON. In our particular case, Mr. Chairman, we are an industrial credit union. We are operating within the house the sponsor owns. We rent the space from them. There usually is not too much travel involved. If in fact the necessity was there for a director or a committee person to travel on credit union business, yes, we would reimburse him for travel costs.

The CHAIRMAN. So the large ones probably, if they're not staying in one geographical area, would do that?

Mr. HUTCHINSON. That's correct.

The CHAIRMAN. Mr. Cugini, do credit unions have the capital to compete with other organizations to offer ATM machines and other technological advances?

Mr. CUGINI. I think that's going to be up to each individual credit union, Mr. Chairman. As we know, probably 60 percent of the credit unions in the United States are very small institutions. However, I think each credit union has to find its own niche and determine what its membership wants. If a credit union is serving a membership that's quite content with 6 percent savings accounts and 12 percent car loans and 5-cent money orders, then, yes, that is what the credit union will offer. But there are those credit unions whose members are demanding VISA cards, checking accounts, all of those good things that most Americans seem to have, and if they are demanding those 7 days a week night and day, then the credit union is going to have to be in a position to offer those, and I think those credit unions can compete in those areas.

The CHAIRMAN. Speaking of VISA and Master Charge, something very nice happened to me in March. My Master Charge expired at the end of March and somehow the bank fouled up and didn't send me any new cards and you know all the money we saved in the month of April without having one?

We're going to see if they can do that every year. If they can screw up for a month, it will greatly help my budget.

INCREASING INSURANCE LIMITS ON IRA'S ABOVE $100,000

Mr. Cugini, you recommend raising the insurance limits on IRA's to above $100,000 and I certainly would agree that IRA's should be safe. But don't you think the institution has some obligation to carry part of that burdon or responsibility rather than just going to 100 percent insurance?

Mr. CUGINI. Mr. Chairman, I said in my testimony that I was from the great State of Rhode Island and my credit union happens to be a State-chartered credit union insured in Rhode Island by a private insurer. We not only have the $100,000 share insurance, but we have $250,000 insurance on IRA accounts. It's working perfectly well because we see that people who retire take a lump sum amount, say $150,000, are not reluctant to put it into the credit union simply because we have that additional coverage, and we don't have a problem with it. We think that maybe this is the way the Federal Government ought to think about it.

The CHAIRMAN. Mr. Hutchinson, with the increasing credit union liquidations and mergers, has the common bond of merged institutions been stretched beyond what we normally think that common bond should be?

Mr. HUTCHINSON. Well, I think that we're recognizing that there have been some new and interesting situations arising in the area of mergers and also in some liquidation cases. I think the fundamental concept of having a common bond still is as strong as it's always been.

Naturally, when you start to look at how you interpret what the law says, much is in the eye of the beholder. To elaborate a bit on that, you recognize that we have had more than one head of the NCUA and each one brings his own team of experts with him to help administer that particular agency.

Their interpretation of the law is not always exactly the same. As you look at that interpretation, however, I think it's an interpretation of how they understand the intent of Congress as the law originally was written. The initial look at that structure was that we had to look at individuals who had a common bond or interest. It also said in the law that groups of individuals should be considered. That second element was overlooked for a number of years; the present administration has chosen to take notice of it.

I don't look at that as a falling away of the common bond concept as much as it is interpreting what the intent was in the initial statement.

We're concerned about it. As a man who's spent 37 years of my life in the credit union world, I am committed to seeing that the common bond concept is continued.

The CHAIRMAN. Well, my concern is certainly that credit unions always be cooperative organizations, that they have an identifiable and related membership, and most credit union people I talk to agree with that because I think it would become counterproductive if it is stretched so far then people start to say, hey, they're going beyond what they were intended to be and there starts to be more pressure to place limitations. So I think it probably has to be more of a self-policing thing.

Mr. HUTCHINSON. I think that is happening, Mr. Chairman. In my written statement I use the example of the Senate Employees Federal Credit Union and its field of membership here in the Senate. I think if you look at that testimony you'll get a good indication of how the common bond really functions.

DISCLOSURE OF PAST DUE LOANS

The CHAIRMAN. Banking agencies are requiring banks to disclose more information about past due loans. What are your views about disclosures, Mr. Cugini, and do credit unions disclose aggregate information on past due loans?

Mr. CUGINI. Mr. Chairman, I don't have a problem with that. I think that it behooves financial institutions to make sure that their lending policies are good policies and sound policies that protect the financial institution and if this is going to lead us into a direction that's going to make us more sound in operations, then I see nothing wrong with that. I know some of the financial institutions because of the Privacy Act have a problem with this, but I think our organization would say that—we would go on record as going along with this.

The CHAIRMAN. Mr. Hutchinson, do you have any comment?

Mr. HUTCHINSON. Yes, Mr. Chairman, I would like to respond to that.

You understand the structure of the accounting procedures for Federal credit unions. It would be almost impossible for a credit union not to disclose a condition of delinquency because by Federal statute we are required to create a reserve for that particular purpose—to take care of the losses on bad loans. That reserve is always stated on the statement that's published each and every month by a credit union and given to the members in their annual report. As that reserve begins to fall the membership knows from that alone that something has happened to the loans. However, Federal credit unions—as a matter of fact, all credit unions, to my knowledge—have been in the forefront of full disclosure of everything. There's been no attempt on the part of credit unions at any time to hide anything, whether it be delinquent loans or anything else. We're in favor of full disclosure.

I think one of the dangers you have to be concerned with, however, if you're talking about the disclosure of individual loans, is that you don't violate the individual privacy of any person. I think you have to be extremely careful in that area.

The CHAIRMAN. Do you break them down into categories, however, of delinquent loans, automobile loans, real estate loans and so on?

Mr. HUTCHINSON. Most credit unions do classify their loans, yes.

The CHAIRMAN. This is a very general question so I don't want you to go into great detail about how do credit union laws differ from the Credit Union Act and most specifically what I'm wondering about is if there are States with broader powers than Federal laws and, if so, how many are broader?

Mr. CUGINI. Mr. Chairman, again, as I stated earlier, my credit union is a State-chartered credit union in Rhode Island and we like to think of Rhode Island as being a leader in having a liberal credit union law. Rhode Island led the Nation in haveing checking accounts, so consequently my credit union has regular checking accounts. Also, Rhode Island is in the forefront on the usury ceiling because I believe I'm correct in saying that they would take—I think it's the 13-week Treasury bill rate plus the prime rate to establish the usury law. So that if inflation did set in, this would be racheted up to something more than the State of Rhode Island usury law which is 21 percent. So in some cases I would have to say that the State laws are a little bit more flexible and lenient than some of the Federal laws.

The CHAIRMAN. Do you have a comment, Mr. Hutchinson?

Mr. HUTCHINSON. I think the comment Mr. Cugini made is very true. The fact of the matter is that if you look at the history of credit unions through the years at one time many States had laws that were much more liberal than Federal law. In the desire to charter a credit union those people organizing a credit union in those particular States looked at the more liberal law to make it more permissive for the individual member to use that organization.

As the Federal law has been expanded and these laws become more and more of equal measure, a lot of that has gone away.

I think that will always be the case when you have a dual system of government where you have State law and Federal law, and I think that's probably good. That touches on the competitive structure of our country. I don't know if that fully answers the question you're asking, but that's the way I look at it.

CREDIT UNIONS AND COMMERCIAL LOANS

The CHAIRMAN. Do credit unions make any commercial loans by having a field of commercial entities or organizations that are members?

Mr. HUTCHINSON. I am not familiar with credit unions that are in the commercial loan business. Maybe Joe has some information on it.

Mr. CUGINI. Very few, possibly State chartered credit unions, could conceivably make a commercial loan because State laws are different. Now we talk about the sort of commercial loan. It could be, for example, a member of the credit union that has a private business and is running let's say a trash truck and may need a $15,000 or $20,000 to buy one of those particular trucks. I'm sure that probably on occasion that maybe a credit union has made that kind of loan, but it's been to member as opposed to a car dealership or something like that.

The CHAIRMAN. From your testimony both of you have indicated that credit unions appear to be doing pretty well right now with their mix of services and apparently this argues against any expanding of credit union powers at this time. Do you feel in the future you're going to need, in order to compete in the field of securities as an example or expanded insurance powers?

Mr. CUGINI. Mr. Chairman, speaking for CUNA, I would have to say that we certainly would not want to be left out of any power.

The CHAIRMAN. I didn't feel you would be.

Mr. HUTCHINSON. Mr. Chairman, I think that's a pretty good answer. It would be unreasonable to assume that credit unions should stand idly by while other organizations changed and went on to do different things.

I think we have to recognize that what we are talking about in credit unions are people. We talk about a lot of people when we talk about credit unions because credit unions predominantly are people organizations more than they are money organizations.

As people change their needs change. We should be able to adapt within the structure of the credit union organization to take care of those needs and changes. I think you would agree with that.

The CHAIRMAN. Well, I expect everybody not to want to be left out. After 2 years of struggling with Garn-St Germain, I'm well aware of how things develop.

Gentlemen, I appreciate your testimony today and thank you very much.

The committee is adjourned.

[Whereupon, at 11:50 a.m., the hearing was adjourned.]

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